PUBLIC FINANCE

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INTRODUCTION BY THE GENERAL EDITOR

SHORTLY after the war of 1914–18 there seemed to be a place for a Series of introductory Economic Handbooks "intended to convey to the ordinary reader and to the uninitiated student some conception of the general principles of thought which economists now apply to economic problems"

This Series was planned by the late Lord Keynes under the title *Cambridge Economic Handbooks*, and he wrote for it a general Editorial Introduction of which the words quoted above formed part In 1936 Lord Keynes handed over the editorship of the Series to Mr D H Robertson, who held it until he became Professor of Economics in the University of London [1]

The judgment of its originators has been justified by the wide welcome given to the Series Apart from its circulation in the British Empire, it has been published from the start in the United States of America while translations of the principal volumes have so far appeared in German, Spanish, Italian, Swedish, Japanese, Polish and Lithuanian

It is symptomatic of the changes which have been taking place in recent times in the development of economic science, changes associated in a high degree with the work and influence of Lord Keynes himself, that within the brief space of fifteen years the text of part of the Editorial Introduction should have stood in need of revision In its original version the last paragraph of the Introduction to the Series ran as follows

> "Even on matters of principle there is not yet a complete unanimity of opinion amongst professors Generally speaking, the writers of these volumes believe themselves to be orthodox members of the Cambridge School of Economics

[1] Professor Robertson now holds the Chair of Political Economy in the University of Cambridge

At any rate, most of their ideas about the subject, and even their prejudices, are traceable to the contact they have enjoyed with the writings and lectures of the two economists who have chiefly influenced Cambridge thought for the past fifty years, Dr Marshall and Professor Pigou"

When the Editorship of the Series was transferred to Mr D H Robertson, Lord Keynes consented to the retention of his general Introduction, but subsequently re-wrote the concluding paragraph in the following form

"Even on matters of principle there is not yet a complete unanimity of opinion amongst professional students of the subject Immediately after the war daily economic events were of such a startling character as to divert attention from theoretical complexities But to-day, economic science has recovered its wind Traditional treatments and traditional solutions are being questioned, improved, and revised In the end this activity of research should clear up controversy But for the moment controversy and doubt are increased The writers of this series must apologize to the general reader and to the beginner if many parts of their subject have not yet reached to a degree of certainty and lucidity which would make them easy and straightforward reading"

Still more recent events have produced a world so far removed from that which existed when the foregoing words were written, that it has fallen to the lot of the present Editor to provide a new Introduction

This is perhaps a good vantage point from which to survey very briefly some of the principal trends in the evolution of economic thought in this country during the past thirty years Prior to 1914, economic theory here was largely dominated by Alfred Marshall, and economists, following him, thought in terms of the long period tendencies of the different sections of the economic system towards positions of equilibrium, even though ever-present dynamic factors were perpetually

modifying the existing structure and presenting new and equally distant, if equally unattainable, goals as stimuli to change and adaptation. Moreover, in the Marshallian system, those tendencies resulted from the working of persistent underlying forces which were conceived of as largely competitive in character. The increasing trend towards monopoly was certainly affecting thought, but not so much in the realm of the theory of value, as in the emphasis which came to be laid on possible discrepancies between the private interest and the social interest. Under the influence of Professor Pigou a Welfare Economics was developing side by side with, and out of, the Value Economics of the older generation.

After 1918 the long-drawn-out agony of the depressed areas, the weakening of the position of this country in international trade, and the tremendous intensity of the economic crisis of 1930–32 (to mention but a few of the many contributing causes) combined, on the one hand, to focus attention on problems of the short period and, on the other hand, to throw doubt on the extent to which the self-adjusting, seemingly automatic mechanism, which on the whole had operated so effectively during the nineteenth century, was capable of coping with the deep-seated maladjustments and disharmonies which characterized the post-war world. At the same time value theory itself was profoundly influenced by the emergence of a number of writers who approached value problems from the view-point of monopoly, and emphasized the unrealistic nature of an analysis which was based on the assumptions of perfect competition and a perfect market. Most of all, however, economic thought was dominated by the desire to find a solution for the problem of how to maintain the level of effective demand so as to avoid the recurrence of phases of deep depression and widespread unemployment. There was a growing feeling of impatience with the economics of the long period "in which we are all dead", and a great, perhaps even excessive, concentration on the short period in which we live and move and have our being.

The result was a remarkable ferment of ideas, the challenging

of ancient orthodoxies, and "for the moment controversy and doubt [were] increased" This ferment had by no means subsided when the second war with Germany broke out in September, 1939, bringing in its train a degree of State interference with the normal peace-time working of the economic system far exceeding that reached even in the last years of the war of 1914–18

In so far as it is possible to foresee future trends, they would seem to lie in a much greater measure of conscious public control over many aspects of economic activity than has existed in the past It will no doubt still remain true, to quote Lord Keynes's Introduction again, that

> "The Theory of Economics does not furnish a body of settled conclusions immediately applicable to policy It is a method rather than a doctrine, an apparatus of the mind, a technique of thinking, which helps its possessor to draw correct conclusions"

Nevertheless, economists may well find themselves to a greater degree than hitherto called upon to express their views on matters of economic policy, and—for a time at least—the writers of future volumes of the Cambridge Economic Handbooks may be concerned rather with specific problems than with the more general aspects of economic theory

C W GUILLEBAUD

Cambridge,
JULY, 1946

PREFACE

THE Preface is traditionally the place where the author endeavours to disarm the critics in advance, by explaining why he has written the book he has, instead of some other book which they might perhaps have preferred The extension within recent years of the subjects which might plausibly be regarded as falling within the province of Public Finance makes this precaution more than ever necessary

Public Finance, it is generally agreed, forms a part of the study of Economics, hence it is mainly the interests of economists which I have had in mind in choosing my subject-matter Some of them may perhaps complain that in that case the book is inordinately concerned with problems of financial administration and accounting This difference in emphasis, as compared with the traditional make-up of books on Public Finance, is quite deliberate As the economic functions of government expand, the technical aspects of finance, of public accounting and of the control of expenditure, assume a new importance As professional economists come more and more to take a direct part in the shaping and administration of public policy, a general knowledge of the functioning of those parts of the administrative machine with which they are particularly concerned becomes (or so it seems to me) a necessary part of their equipment In application, and in such description as has been necessary, I have mainly and inevitably been concerned with British institutions, but I have tried to take examples from other systems whenever possible

As a result of this expansion on the administrative side it has been necessary, in order to keep the book within reasonable bounds, to trim it fairly finely in some other directions The exclusions have again been deliberate, they are concerned with outliers in the field of Public Finance which in my view can best be cultivated within the system of the neighbouring

fields to which they belong as much as to the field of Public Finance Three of the outliers are so important that they call for brief comment

In the first place the discussion is primarily concerned with the activities of *governing bodies* The economic problems (e g price and outlay policy) as distinct from the financial problems of socialized industry, of public boards and of public utilities are not considered, except in relation to their place in a systematic policy for the economy as a whole, discussed in Part III A full-dress treatment of the problems of Public Economics is urgently required, but it cannot be provided as an annexe to a book on Public Finance

Secondly, I have omitted any technical discussion of the process of public borrowing and of the management of the Debt This limitation may well appear unjustifiable, since with the nationalization of the Bank of England the boundary between public and private finance in this sphere appears to be substantially shifted outwards The omission is again partly owing to lack of space, but mainly owing to the fact that the introduction of technical detail in a book of this nature would require a description and interpretation of monetary and credit institutions which belong more properly to the field of money and finance In spite of the nationalization of the Bank it is still plausible, and in many ways convenient, to distinguish between changes in the monetary situation which are due to efforts on the part of public authorities to influence that situation, and changes which result from activities of public bodies in pursuit of other ends I have endeavoured to exclude the former but to include the latter

The third omission will probably be found, under present conditions, the least forgiveable Economists will look in vain for an adequate treatment of international fiscal relations Here above all it seems to me that fiscal consideration cannot usefully be discussed in isolation from the other factors which go to make up the international situation, and from the other instruments of policy—monetary and exchange action on the one side, direct controls on the other—by which a nation

endeavours to keep its feet in the world economy Had I once entered this territory there would have been no practical stopping place

A first draft of this book formed part of the course for the School of Special Studies in Economics in the University of Liverpool I am much indebted to Mr Henry Hartley, Lecturer in Public Administration in Manchester University, for advice on the parts of the book which border on administration If any administrative errors remain it is not his fault

My main debt, as ever, is to my husband Some considerable part of the discussion stems from our joint work, in the fields of local finance and war finance respectively For much of the theory of tax incidence (especially in Chapter X) I have drawn heavily on his published work, and still more heavily on his time for innumerable discussions of difficult points Worst of all, I have in Chapter VII been compelled by the nature of my approach to take a first, and inevitably immature, crop from a field—the theory of the social advantage—on which he has himself as yet hardly had time to carry out the first operations in the process of cultivation For this I owe him a deep apology

URSULA K HICKS

Oxford,
APRIL, 1946

PREFACE TO THE SECOND EDITION

THE first impression of *Public Finance* went to press in April 1946, too early to foresee even the outline of the postwar world In 1949 I was able to take advantage of a new impression to record a few of the already great changes that had taken place in the short space of three years Now after close on ten years it is high time to undertake a more extensive revision, especially as it begins to be clear which of the war and immediate postwar changes have become permanent features of the British economy It is evident that the major developments of social expenditure have come to stay, more especially the National Health Service and the extension of social insurance to the whole nation On the other hand the abolition of controls, allocations and rationing have now made the economy in some ways more like that of the prewar world than that of 1946–49 All these changes are reflected in the system of public finance, so that wherever possible I have compared the situation as it was in 1953 (the latest complete year available) and 1938 In Chapter XVI in particular I have tried to indicate the consequent changes which have taken place in the distribution of incomes and in their redistribution through progressive taxation and social expenditure But the data for a complete survey comparable with those made for 1937 are not yet available

Over recent years no change has been more significant than the continuing process of strengthening and expanding the Treasury to enable it to perform the important new tasks of fiscal policy The seal has here been set on the new organization of the departments responsible for the preparation of general economic policy by the transfer of the Economic Section from the Cabinet Office to the Treasury I am very

grateful to the courtesy of the Treasury officers who have overseen my account of these matters The fruits will be found partly in Chapter III, concerned with the administrative set-up, and partly in the final chapter Although the Budget does not yet itself formally reflect the immense progress which has been made in the art of national accounting, in the statistics on which it is based and in its applications to policy, the new outlook is already apparent in Budget speeches It is perhaps even possible to discern the direction in which budgetary reform will develop at the next stage

In view of the now far greater importance of *Public Finance in the National Economy*, as a matter of normal life and not merely in a transitory phase of emergency, I have rewritten the whole of Part III which is concerned with such matters In Chapter XVII I have treated those aspects of fiscal policy which are concerned with stability at a high level of employment, dealing separately with the problems of inflation and unemployment, since neither their analysis nor their treatment is symmetrical Chapter XVIII contains new matter concerned with the part which fiscal policy can play in promoting growth I have been led to this partly through the new emphasis on increasing productivity which has been necessitated in Britain by reason of her balance of payments difficulties, partly on account of the many new problems with which public finance is being confronted in respect of the development of the backward countries of the world While I would be the last to suggest that either the problems of these countries or the means of meeting them are homogeneous, it seems to me that a number of problems can nevertheless be usefully treated in a general discussion, both in respect of the role of fiscal policy in promoting development without inflation and in the use of the budget as an instrument of policy in the more primitive economies

Finally the revival of the monetary instrument of control in the autumn of 1951 puts the whole question of debt management, treated in Chapter XIX, in a new setting It is not to be hoped or expected that the new monetary policy will oust

fiscal policy from its now established position of pre-eminence as a means of implementing economic policy Rather we should now look forward to a world in which the two instruments can cooperate to enable the nation to make the best use of its economic resources

URSULA K HICKS

Oxford,
JULY 1955

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PUBLIC FINANCE

PART I

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CHAPTER I

THE STATE AS EMPLOYER AND PRODUCER

§ 1 **Private Enterprise and Public Service** In Britain, and in countries organized like it, the population can be roughly divided into two groups The first group consists of those who are dependent on incomes derived from the production of goods and services destined to satisfy (directly and indirectly) the personal wants of consumers, they produce because they anticipate that consumers will be prepared to pay prices for the goods sufficient to make their continued production worth while The second group is engaged in providing services (and in some cases goods) whose scope and variety are determined not by the direct wishes of consumers, but by the decision of government bodies, that is, in a democracy, by the representatives of the citizens

In public finance it is with the activities of this second group that we are most directly concerned The workers in it are, like the workers in the first group, occupied in satisfying consumers' wants, but many (although not all) of the wants are of such a nature that the means of satisfying them cannot be split up into units and sold through the market mechanism (for instance, police protection), the wants have therefore to be satisfied by collective provision

Since services of this nature cannot be paid for directly by the users, the incomes of producers are not derived from the

sales of their output; instead these "public services" are paid for out of taxes—compulsory transfers of private incomes to governing bodies for the express purpose of arranging for the collective satisfaction of wants. The fundamental difference between this and the market method of finance is that there is no relation between the tax liability of any individual and the share of collectively provided services which he will be able to enjoy. Nor, save in very exceptional circumstances, can the revenue from any particular tax be regarded as paying for any particular service. Taxes are paid into a pool; entirely separate decisions govern the distribution of revenue between the public services.

Workers in the first, "private enterprise", group are organized in a great number of different ways. At one extreme they may work on their own, with only the assistance of their families, as many farmers do; at the other they may work for a giant firm, employing tens of thousands of workers. Whatever their size, all these organizations have this in common, they are independent units, and all, the one-man firm and the big company alike, are motivated by the principle of incentive or profit. The goods and services which are produced are conditioned by the continued receipt of more satisfactory incomes than could be secured by producing other goods and services.

The public service is also organized in groups—the departments of the central government and of the "local authorities" (the corporations of large towns and the councils of counties, small towns and rural areas). In this case, however, the groups are not independent; they work as parts of central and local governing bodies, and in the last resort all are subject to Parliament. Their activities are not in process of continuous adaptation to the anticipated demands of consumers, as is the case with the private enterprise groups. On the contrary what they do, and largely the way they do it, are prescribed by the previously expressed decision of the bodies whose servants they are, and ultimately by Parliament. Their work can only be varied when these bodies decide to alter their policy. The

continued production of particular public goods and services is independent of their cost because since the government's power of taxation is unlimited, revenue can always be made available to cover any agreed extension of output

To this division of the population between "private enterprise" and "public service" there is one important qualification It is common, and for some purposes necessary, to include among the public services the nationalized industries (public corporations) and trading activities of the departments of the central government and of the local authorities, which provide goods and services to be sold on the market, like the output of private enterprise

In spite of the fact that the units are not independent, the organization of this "public enterprise" is more nearly akin to that of "private enterprise" than to that of the remaining public services Public enterprise is essentially motivated by the principle of incentive, in that the scope and direction of its activities are determined by the anticipated direction of individual consumers' wants This similarity between public and private enterprise is often concealed by the fact (as in Britain) that the public trading services are planned in such a way that the gross returns cover only costs, excluding what private firms would regard as a necessary profit Since any loss which may be incurred by a public trading department can in the last resort be covered by taxation, there is no room for ordinary shareholders who are prepared to bear the risk of loss in return for the chance of profit

The kinship of public enterprise and private enterprise is shown by the absence of any logical line of demarcation between the two In Britain, for instance, the provision of gas, water, electricity and local transport—the typical trading services of the local authorities—was developed partly by public and partly by private enterprise Again the British Transport Commission, established in 1948, was designed to take over both the railways (operated by large companies subject to much control and regulation) and road transport which mainly consisted of small independent units From 1954 the B T C

was shorn of this latter function, road transport returning to private enterprise Similarly, civil aviation is being developed partly by the publicly owned Airways Corporations, partly by private companies operating under licence

There is, however, a significant difference between the independence of the private firms producing services of this type, and the remainder of the field of private enterprise Owing to the monopolistic nature of the services, it is necessary in the public interest to subject the firms to a high degree of regulation, especially in respect of price policy Such industries are consequently known as "public utilities" The firms are nevertheless private in the vital sense that the capital is the property of the shareholders and the directors are chosen by the proprietors

In the inter-war period a new form of semi-public enterprise made its appearance in Britain Prominent examples were the Central Electricity Board and the London Passenger Transport Board These "public corporations"[1] were bodies controlled by boards of directors, with similar rights and duties to directors of privately owned companies, but appointed by the government This form of organization was the prototype of the nationalized industries established between 1946 and 1949 The essential difference between the public corporation of the 1930's and these later creations is that the latter are each related to a sponsoring Ministry (the Ministry of Fuel and Power or the Ministry of Transport), and are subject to direction by the Minister, who also answers for them in Parliament The new type of public corporation is thus much more closely integrated with public policy than were the corporations of the 1930's, but in matters of day-to-day organization of production and sales they function as much as possible along the lines of a private enterprise company They thus also differ from the old form of nationalization, typified by the Post Office,

[1] This must be carefully distinguished from the "public company" which is merely a private firm with a particular form of organization compelling it to publish its accounts This caution is especially necessary in respect of the U S A where the term "corporation" is equivalent to the British "company"

services which are conducted almost as if their functions were purely administrative

The public corporation form of organization is capable of very wide application in modern conditions Abroad it has been put to uses varying from the exploitation of a public monopoly (e g tobacco) as a method of raising revenue, to schemes of large-scale social regeneration (as in the famous Tennessee Valley Authority in the United States)—in addition to its more orthodox use of marrying public control and business efficiency Similarly, the degree of public control is capable of great variation

From this discussion it will be apparent that the line between "public" and "private" needs to be drawn with a good deal of flexibility in modern conditions What then is the scope of public finance? For most problems it is convenient to draw the line short of the activities of public enterprise, that is to say of its price and output policy, for the reason that policy decisions in this field are mainly determined within the industries on economic rather than on political or social grounds The problems which public enterprises have to solve are essentially those of firms and not those of governing bodies The main content of public finance consists then of the examination and appraisal of the methods by which governing bodies provide for the collective satisfaction of wants, and secure the necessary funds to carry out their purposes

In view, however, of the control which the government exercises, not only over public corporations and other forms of trading service, but also over the privately-owned public utilities, when we are concerned with the broader aspects of policy—with questions of maximizing national income and welfare, policy which must also be considered to fall within the sphere of wants collectively satisfied—it is necessary to take into account not only the activities of governing bodies but also of all organizations whose policy is subject to some degree of public control [1]

[1] For the sake of completeness we should include here the public credit organizations, although their problems belong mainly to the field of

§ 2 The Public Sector and its Finance. In a democracy, as usually understood, the State (which term is a convenient shorthand covering both major and minor governing bodies) is a particular part of the nation's organization In its economic and financial aspect it may conveniently be referred to as the "Public Sector" of the economy, a term which is then contrasted with the "Private Sector" comprising the social and economic activities of the community in pursuit of their individual private aims Since the business of the State is the satisfaction of wants, public finance is essentially a department of economics It is one aspect of the economic problem of securing the best application of limited means to secure given ends, the ends in this case being given not by the demands of consumers on the market, but by policy determined by the representatives of the people sitting in the governing bodies of Parliament and the local authorities

The public sector of a modern nation is an organization of great size and complexity, and of growing importance in the life of the community This is as much true of countries such as Britain and the United States, which formerly followed a *laissez-faire* tradition, as of countries (such as Sweden among the western democracies) where there has long been a tradition of public ownership One of the most striking and universal phenomena of recent years has been the rapid expansion of public sectors

Measured in terms of purchases of goods and services, the British public sector had come by 1938 to represent about one-fifth of the total activities of the economy, whereas before 1914 it was of the order of only one-seventh In 1938 something like a million and a half workers (out of a total of 20

monetary policy and not of public finance Those which are most concerned with the implementation of public finance policy are the organizations for supplying long term credit—for public investment (the Public Works Loans Board) and for approved private investment (a function performed by several organizations sponsored jointly by the Treasury and the Bank of England)—and, in the background the Bank of England itself whose task of providing the necessary monetary circulation for the country was under the effective control of the Treasury long before the Bank was nationalized

million) were directly engaged in producing goods and services required for the collective satisfaction of wants, while in addition, at least as many were on the average employed in producing goods and services subsequently purchased by the public sector for the collective satisfaction of wants. During the war these numbers expanded enormously and are unlikely ever to fall back to the 1938 level. Among the direct employees of the State must be reckoned not only civil servants and teachers, and the administrative clerical and manual staffs of local authorities, but also the armed forces and the diplomatic corps. The goods purchased by the State from private enterprise range from tinplate and steel for battleships to the chalk and dusters, milk and orange juice, supplied to elementary schoolchildren.

As we have seen, the labour and materials necessary for the production of these goods are paid for by taxes levied on all members of the community (including the employees of the State). Besides taxation (and more rarely the use of the profits of public enterprise to finance general government expenses) the State can also borrow the capital of private citizens. In the past the British government has almost entirely confined its borrowing to war periods, when the necessary expenditure exceeded what could be extracted from the incomes of citizens by means of taxes; public enterprises, however, frequently borrow in order to finance long-term investment, in a manner analogous to the debenture borrowing of private enterprise.[1]

The importance of loan finance greatly increased during the inter-war period, and we shall have to pay especial attention to the problems which it raises. Nevertheless, the funds spent by States are likely to continue to be mainly derived from taxes. This statement applies equally to a totalitarian state such as the U.S.S.R., since the citizens (who are then almost without exception state employees) receive their incomes *net* of a deduction which corresponds to a basic tax payment in other countries. In addition, the Soviet Union also levies some further taxes of a more special nature. It is therefore with

[1] The largest item of public borrowing to finance investment (fixed capital formation) is for the construction of houses by public authorities.

taxation and its problems that we shall be mainly concerned on the receipts side of public finance

The activities of the public sector are determined primarily by political considerations, which are a datum for the economic system, either private or public This does not imply that policy can only be based on party considerations, on the contrary it is possible (as we shall see), and it is moreover absolutely essential for the formulation of a rational policy, to set out in a systematic and objective manner the principles by which the wealth and welfare of the community can best be increased Once this has been done it is the duty of the adviser on public finance to show what types of public outlay, and what choice of taxes, are most appropiate for attaining the ends laid down

Although public finance is the servant of policy it has itself an importance which has often reacted on the political situation It is hardly too much to say that the permanent well-being of a nation depends as much on the successful solution of the problems of public finance as on the skill and industry of its workers or the bravery of its soldiers The path of history is strewn with records of national failures which illustrate the vital nature of public finance Tax bankruptcy was an important contributory factor to the fall of the Roman Empire Unjust and inefficient taxes set the French Revolution aflame An important part of the explanation of Germany's failure in the war of 1914–18 was her antiquated tax structure, which proved unequal to the task of controlling civilian consumption, so as to secure proper concentration on the war effort

Again, in many countries, in England above all, it is in the field of public finance that the decisive battles for personal and political liberty have been fought The struggle for the very existence of Parliament centred on the financing of Edward I's wars The freedom of the House of Commons was won over the question of Charles I's Ship Money, and its dominance was finally confirmed against the power of the House of Lords as a result of the struggle for the Finance Act of 1911 [1]

[1] On the other side it must not be forgotten that inefficient taxes helped to lose Britain the American Colonies

§ 3 The State and the Individual The State is part of the organization of a nation What then, we must inevitably ask, is the relation between it and the individuals and smaller groups of which it is composed? This is primarily a political question, the answer to which differs enormously according to the type of political organization in force We do not need to consider the question at length here, since it belongs to the field of politics, but we shall not understand the significance of British public finance unless we have some broad, but fairly definite, concept of the relations between the State and the individual in such a democracy as Britain Let us start by considering more closely the nature of the wants which the State exists to satisfy

In the first place we must notice that although the public services cater for the satisfaction of wants by collective means, the satisfactions themselves are individual (since only individuals can experience satisfaction) In the same way commodities may be said to be taxed, but the taxes are paid by their owners or users Many of the satisfactions provided by the State, however, cannot be provided individually—as we have seen the services of the police (and also of the armed forces) are by nature indivisible As soon as community life is established social wants of this sort are felt, and must be satisfied, either by the citizens acting directly or through an agency We can thus regard the State as an agency acting for the citizens to provide collectively for their wants

Thinking along these lines the State has been likened to a sort of super club, owning and renting property, for instance, as a golf club does, and employing servants to provide collective services, as a golf club employs greensmen and waiters to minister to the needs of the members For understanding many of the functions of government this is a useful analogy, but we must beware of pressing it too far A club is a voluntary organization which can be joined or resigned from at will Failure to pay the subscription can lead to nothing worse than suspension of membership, and there is no compulsion on anyone to join a club at all The State can only be resigned

from by the difficult means of emigration, and it is very uncomfortable to exist in a "stateless" condition Failure to pay one's "subscription" (taxes) to the State is punished by imprisonment

The compulsory nature of obligations to the State gives rise to important questions of social justice For instance, there is nothing objectionable in having a golf club subscription which is uniform for all the members, because membership is voluntary, those who think that it is too high will simply not join, but to impose uniform taxes on all citizens irrespective of their incomes is recognized as being very unfair indeed An important part of public finance is concerned with questions of the proper distribution of tax liability between citizens with different incomes

A parallel distributional problem arises also on the side of public expenditure Members of golf clubs have similar tastes and expect to enjoy the same services, different individuals have not the same desire or need for public goods and services, consequently it cannot be expected that everyone will agree in detail on the wants to be satisfied by public authorities In fact a considerable part of the need for public services really arises from the conflict of interests which must always exist between different individuals and classes—the difference between the shopkeeper and the burglar, no less than between the old-age pensioner and the schoolchild, or the ratepayer and the unemployed

In countries where the distribution of State expenditure is determined in a democratic assembly the policy—and the public finance—which emerges is patently the result of compromise between conflicting interests, in countries where policy is imposed by the will of a ruling clique or class, the conflict is no less urgently present, although it is driven underground In such circumstances indeed the club analogy is no longer appropriate

Although in a democracy the club concept of the State remains useful from some points of view, as a comprehensive account of the relation between the State and the individual it

now appears altogether too narrow and passive The internal functions of the government, for instance, can no longer be conceived in terms of "holding the ring" between different interests, and of providing "amenities" of the type of street lighting and cleansing (which were the typical examples of what was regarded as "beneficial expenditure") The concept of the proper sphere of the State's activities must be extended in two important directions

In the first place it is rapidly coming to be accepted that it is the business of the State to ensure that every citizen can enjoy the primary necessities of life—sufficient and correct food, adequate shelter, and health and education services commensurate with his needs It is now widely held that the State should ensure this minimum by itself buying or producing and distributing the means of satisfying these primary wants, wherever it is apparent that the field is not being adequately covered by private enterprise In the second place it is now held to be an overriding duty for the State—which alone can undertake the task—to secure the maximum level of economic activity and of social welfare which the resources of the economy permit These two extensions of the concept of the sphere of the State imply a new and more intimate relation between the State and the individual, both in his capacity of producer and of consumer, they also imply a considerable expansion of the types of public activity

The State thus tends to figure more definitely as a producer and employer Production is still mainly of services, but the importance of goods, both for current use and as permanent assets, is rapidly increasing Houses were but one—and the first—example of the sort of capital goods which can usefully be produced by the State to supplement the output of private enterprise As the capital equipment of a nation increases, and consequently the profits which can be derived from producing further units tend to decline, an extension of public investment may well be the most fruitful method of raising the productivity of the economy We shall have to consider this question and its bearing on the future organization of public

finance when we have completed our investigations into the different parts of the system

With its new duties in mind it may be useful to think of the State as a giant firm, owned and run by the citizens for the purpose of producing or purchasing, and distributing, goods and services both to provide collective services in the old sense, and also to satisfy those individual wants which it has been collectively determined should be satisfied This way of regarding the State is especially useful for public finance because it focuses attention on the economic aspect of the State The best way to discover how a firm's activities are distributed and how they are prospering is to examine its balance sheet If we similarly examine the State's "balance sheet" we shall have made considerable progress in discovering how the public sector works In fact, it is by means of a modified balance sheet (the Budget Accounts) that Parliament annually reviews policy

There is one complication, however, about regarding the State as a giant firm The functions of government, the distribution of expenditure and the collection of taxes, are not the monopoly of the national government, but in almost all countries are divided between a major central government and minor local units (This suggests that the analogy of a holding company and its satellites would really be more appropriate)

Just what relations are established between the central government and the local units differs greatly from country to country In the United States there exists a regional government (the State of California) of such importance that it has a jurisdiction of 240,000 sq miles and a population of over 10 millions, the State legislature being a major government for a large number of local authorities The State government of California exercises wide independent tax powers and in most aspects of internal administration can frame its policy without regard to other jurisdictions At the other extreme we might instance a French Commune of a few hundred souls, which for all major policy decisions is dependent on the central government, but yet still possesses a distinct

community life of its own In Britain, in spite of the fact that the national government is unitary and not federal, the collective importance of the local authorities is by no means negligible, not merely in carrying out policy, but also in framing it

Notwithstanding the wide powers which may sometimes be enjoyed by minor governments, the central government of a country must always retain pre-eminence both in general and in financial policy This is inevitable, since the national government is charged with decisions which are vital to the existence of the nation, decisions relating to war and peace, and all relations with other nations Internally also the pre-eminence of the central government tends to increase as the scope of public activity expands, for a systematic economic policy concerted action, directed by the centre, is an essential pre-requisite Thus the finance with which we shall mainly be concerned is that of the central government, but we must not allow it to monopolize our attention completely Local authorities make an indispensable contribution to democratic organization The best method of integrating their policy and finances with those of the central government, without sacrificing their independent life, presents one of the major problems of modern democracy

CHAPTER II

THE NATURE OF PUBLIC EXPENDITURE

§ 1 **The "Duties of the Sovereign"** There is a fundamental difference between public and private finance which it is useful to note at the very outset of our investigations Private finance, whether of firms or individuals, starts with a given income as the framework within which expenditure must be planned, public finance in a modern state starts with a given expenditure plan, and the authorities adjust their "incomes"[1] (revenue) by means of taxes and other resources, to match the expenditure[2] There is naturally an ultimate limit to the amount that public authorities can spend, set by the amount which it is necessary to leave for the support of the citizens, within this limit of "taxable capacity" there may well be another, set by the proportion of their incomes which people are prepared to devote to the collective satisfaction of wants, but that, in a democracy, is a matter for discussion and persuasion

Since expenditure and not revenue is the governing factor in public finance, it is more logical to start with the expenditure side of the account British State expenditure is set out annually in great detail, in the estimates and appropriation accounts of the central government and the financial statistics of the local authorities, but in order to arrive at a coherent picture it is necessary to group the services in some sort of functional manner

The first systematic discussion of public expenditure in Britain was contributed by Adam Smith in the *Wealth of*

[1] The only true incomes of public authorities are those derived from property and trading

[2] In poor and undeveloped countries where the raising of taxes is a difficult matter it may still often be necessary to plan the budget from the revenue side

Nations, published in 1776 Smith has a memorable chapter on what he calls "The Expences of the Sovereign or Commonwealth" (or as we should say, the State) His discussion had a profound effect on his contemporaries, we know from his own words that William Pitt, the father of our modern financial system and one of our greatest financial administrators, was profoundly influenced by Smith's writings We cannot do better than apply Smith's classification of the "duties of the Sovereign" as a basis for our picture of public expenditure

According to Smith the "duties of the Sovereign" fall into three classes The first duty of the State is that of "defending the society from the violence and injustice of other independent societies", the second is that of securing internal justice between citizens It is obvious that these are primary tasks for any government, it is almost impossible to conceive of any stable political system in which they are not recognized as fundamental Vital differences in practice may, however, arise in the interpretation of the second duty, history has shown that slaves and particular racial groups may be far from enjoying the elementary rights of citizenship in otherwise civilized states

For modern conditions Smith's "third duty" is much the most interesting, although it is not fundamental, in the sense that an organized community can exist even if it is omitted altogether, it is only as the income of a community begins to rise that it becomes of importance Smith defines his third duty as "erecting and maintaining those public institutions and works, which though they may be in the highest degree advantageous to a great society, could never repay the expense to any individual" Chief among such "works" he considers "those for facilitating the commerce of the society, and for promoting the instruction of the people"

In modern terms Smith's third duty would be described as expenditure for economic and social ends It is remarkable that in eighteenth-century England Smith already envisaged the development of these two branches of public expenditure,

which have now come to transcend all others in size and importance, and moreover Smith evidently realized the part which the State could play in providing collective services which might be desired by all, but would yet be beyond the scope of private enterprise Smith's balanced position is a complete answer to the charge that a rigid interpretation of *laisser-faire* has been part of the British tradition

Let us now see how Smith's "three duties" have been interpreted in modern Britain [1] Defence expenditure to equip modern forces is a very complicated affair, it must provide for capital equipment, factories and barracks as well as ships, aeroplanes and tanks required for active service, it must also provide for stores—technical equipment on the one hand and clothing on the other—which form the "working capital" of the defence machine Finally, a large proportion of defence expenditure is devoted to the payment of wages and salaries (in cash and in kind) of active personnel and of pensions to retired members of the forces From a consideration of the variety of this expenditure it is easy to see that substantial changes in the needs of defence affect directly almost every part of the economy There is no other form of public works which is so influential in determining the level of economic activity

Adam Smith was much impressed by the burden of defence expenditure and with the way in which it was tending to increase in his day This was largely due to the troublous times in which he lived, the same complaint was frequently heard in the inter-war period Actually in time of peace, defence expenditure has not tended to consume a large proportion of the resources of the British economy In the inter-war period, before the beginning of rearmament in 1937 it amounted to about 2 8 per cent of the net national income (including war pensions), this represented about 15 per cent of

[1] For an account of the development of British public expenditure, cf U K Hicks, *The Finance of British Government, 1920 to 1936* (1938) and *British Public Finances, Their Structure and Development, 1880–1952* (1954)

the total outlay of the State excluding national debt interest By 1944 defence expenditure had, however, risen to some 80 per cent of total public outlay After 1945 it quickly declined and was back to under 7 per cent of the net national income by 1950, only unhappily to rise again with rearmament consequent on the Korean crisis In 1953 defence expenditure amounted to about 9 per cent of the net national income

The "second duty"—of internal justice—is also partly a matter of defence Peaceful and law-abiding citizens require protection from their more unruly neighbours The final coercive power of the State over all classes of citizens is as fundamental for the stability of the community as its defence against external enemies The maintenance of justice between citizens in the complications of modern life requires, however, a much more extensive mechanism than the mere apparatus of police, law courts and prisons The cost of making and administering laws, the work of Parliament and of the departments of the central government—especially the Treasury and the Home Office—and the administrative work of the local authorities must all be included It would be more accurate to-day to describe the second duty as that of civil government, a very important object of which is to see that full and equal justice is done, in all respects, between one citizen and another

The "second duty" thus defined has two aspects, one protective, the other administrative The scope and cost of the administration have increased enormously since the eighteenth century, *pari passu* with the growth of the public sector, nevertheless the protective side (police, justice and fire services) still accounted for more than half the outlay on civil government in the inter-war period It is important to notice that while the finance and execution of the "first duty" are wholly the business of the central government, responsibility for the "second duty" is shared between the central government and the local authorities, the greater part of the costs falling on central finances but the greater part of the work being carried out by the local authorities The outlay of the State on civil government in the inter-war period amounted to about

6 per cent of total public expenditure [1] In spite of its primary importance the "second duty" is no longer one of the major calls on the community's resources

In Adam Smith's day public expenditure for social and economic ends was on a very modest scale Public social expenditure was confined to the Poor Law, universal public education still lay nearly a century in the future, although a first grant towards it was made within thirty years of Smith's death Nevertheless, the period was one of awakening social conscience, as is apparent from the spontaneous local additions to public assistance which were made during the Napoleonic wars (and which became famous as the "Speenhamland System") The very fact that Smith included public instruction among the duties of the Commonwealth is highly significant—it must be remembered, however, that he was a Scotsman

In Smith's day the greater part of public efforts "to facilitate the commerce of the society" took the form of a complicated system of protection, drawbacks and bounties designed to forward the interests of particular groups Smith regarded this type of public activity with scant favour, and it was largely due to his influence that in the following generation a great deal of the apparatus was swept away On the other hand Smith was a keen advocate of public works of the type of road construction, which he conceived as operated on a commercial basis (by means of tolls), and which, as he rightly perceived, would greatly increase the productivity of the economy [2]

§ 2 **Expenditure for Economic Ends** In modern conditions State expenditure for economic ends also consists of direct services to private enterprise on the one hand and benefits to the community at large (for instance through the socialized

[1] Excluding interest on the National Debt

[2] Cf *Wealth of Nations*, Book V, Part I, "as the expense of the carriage is very much reduced by such public works, the goods notwithstanding the toll, come cheaper to the consumer than they would otherwise have done, their price being not so much raised by the toll as it is lowered by the cheapness of the carriage"

industries) on the other Each of these may, if properly directed, "facilitate the commerce" (in modern terms increase the productivity) of the economy Expenditure in aid of private enterprise is of two types, the first finances the provision of services useful to all, or to a great variety of industries, the second confers favours on particular branches of production, especially on agriculture Of the first, typical examples are the work of the Department of Overseas Trade, of the Weights and Measures Department of the Board of Trade, the Employment Exchanges of the Ministry of Labour and the research work of State institutions [1] The State is in a unique position to provide such services and they might well be extended, with great advantage to the community

Public outlay in favour of particular industries has taken the form of subsidies of different kinds, direct and indirect, open and concealed, and has usually been backed up by direct controls (e g, quantitative limitation of imports), so that the effect of policy greatly transcends the direct influence of the relatively moderate expenditure Benefits have frequently been accorded on strategic or sentimental rather than on economic grounds Expenditure of this nature is closely parallel to the eighteenth-century measures which Smith condemned and he would doubtless have taken a similar view of much modern policy A general expansion of this type of public outlay took place in the inter-war period, first as a result of dislocations and changes due to the 1914–18 war, later in attempting to mend depression conditions Subsidization and protection of particular industries, especially agriculture and shipping, was an important contribution to international political tension in the 1930's In Britain expenditure of this nature grew from about £30 mn in the later 1930's to a maximum of £99 mn in 1947 Thereafter it gradually declined, reaching £48 mn in 1953

In Britain the socialized industries—apart from the Post

[1] Except where the research is undertaken at the request of a particular firm, when it is virtually treated as a trading service and provided against a fee

Office services—grew up under local rather than under national control, and were somewhat hampered in their development by the awkward distribution of local jurisdictions—determined largely by historical accident The first step in nationalizing the local trading services was taken by the establishment (in 1926) of the Central Electricity Board to co-ordinate the production (but not the distribution) of electrical current In addition to the orthodox trading services some local authorities own more adventurous enterprises—Doncaster's race course and Colchester's oyster beds are favourite illustrations Probably many more local authorities would be prepared to venture in other directions if they could obtain the authorization of Parliament without undue expense and delay

Traditionally the only important trading service of the British central government was the Post Office, but it is only in the present century that control over the telephone was made complete, other telecommunications were added in 1946, although the extension had virtually been agreed on during the war Broadcasting on the other hand has from an early date been a national service, controlled by a public board The central government has also long operated a few additional enterprises, small but efficient, ranging from H M Stationery Office to a stake in the public house business known as the "State Management Districts" of the Carlisle neighbourhood The years 1946 to 1949 saw the establishment of the great nationalized industries in 1946 the Airways Corporations (the Bank of England was also nationalized in that year), the National Coal Board in 1947, the British Transport Commission and the British Electricity Authority in 1948 and the Gas Council and Area Boards in 1949

Although there are considerable differences from country to country, broadly speaking the same sorts of industry have tended to get nationalized everywhere, namely, those which in time of emergency it is vital for the State to control, such as the postal services, broadcasting, and the road system (which in many respects deserves to be classed as a trading service),

or alternatively those which have an inherent technical tendency towards monopoly, mainly because their overheads are enormously high relatively to running costs, such as gas, electricity and transport It will be seen that the British nationalized industries conform closely to type

In Europe—in contrast to Britain—it has long been more usual than not for the railways to be nationalized, but other public utilities are State controlled to very varying degrees Some governments (e g in Sweden) also own such things as ore and timber reserves, and these are mainly operated through public boards In the United States on the other hand, prior to the New Deal Administration, the Post Office was virtually the only nationalized industry, even now the telephone and telegraph are not under public ownership On the other hand individual American cities sometimes operate extensive trading services [1]

The determination of the proper limits for public ownership or enterprise falls outside the province of public finance, so that we cannot discuss them here In practice policy tends to be directed by political rather than by economic considerations, but that is not as it should be, since the basis of an objective decision on economic grounds could be established It cannot be assumed *a priori* that public operation will secure maximum efficiency [2] On the one hand nationalization offers the best prospect of adjusting the size of the units of control to the technical optimum—a consideration which is particularly important in the technical monopolies—on the other the measuring rod of efficiency in public enterprise (production at minimum social cost) is less convenient as a directive than the

[1] The city of Jacksonville is quoted as deriving over 30 per cent of its revenue from public enterprises, cf Hansen and Perloff, *State and Local Finance in the National Economy*

[2] Thus there is reason to believe that the British economy would have profited by a more forward policy of telephone development, cf Robson, *Public Enterprise* An important factor in delaying development has been the way in which the prosperous telephone services are made to carry the unremunerative telegraph services This is a form of economic waste which may be a particular temptation to public service

private enterprise measure (of maximizing the difference between costs and receipts) Only if a systematic enquiry has been made, based on objective policy criteria and statistical investigation, can it be determined in any particular case in which direction the balance of social advantage lies Economic expenditure of other types should also be subjected to periodical statistical check of efficiency, since if they do not lead to an increase in productivity their right to exist is very questionable

§ 3 **Social Expenditure in the Modern State** Social expenditure has for some generations now absorbed by far the largest share of British public outlay in normal times The country has a long tradition of social service Even in the early nineteenth century expenditure on poor relief was large relatively to the national income, although it declined towards the middle of the century with the rise in Victorian prosperity and the rigours of the "New Poor Law", by that time, however, other social services were beginning to supplement its efforts Before the middle of the century exchequer grants were given towards education services, public education as a State service dates from 1870 Public Health services also started before the middle of the century (when they were much stimulated by the effect of a devastating cholera epidemic), they were greatly extended in the early years of the present century, again as a result of the 1914–18 war A still further expansion took place after 1945

Social insurance and old age pensions were introduced by the Liberal Administration of the first decade of the present century, they expanded in the inter-war period, but it was not until the legislation of 1946–48, implementing the "Beveridge" Report[1] of 1942 that social security was welded into a nation-wide system House building by local authorities started as a tiny trickle just before the war of 1914–18, by the late 1920's it had expanded to a major national service,

[1] Report of the Interdepartmental Committee on Social Insurance and Allied Services

altogether public authorities built one in four of the inter-war houses In the years immediately following the second world war the "industry" of house building may almost be said to have been "nationalized", between 8 and 9 of every 10 houses were erected by public authorities, and a higher rate of building was reached than had ever been attained in the inter-war period The early 1950's saw the gradual revival of private enterprise building but without, initially at any rate, any appreciable decline in the activities of public authorities It can safely be asserted that already in the inter-war period Britain was providing social services on a more generous scale than any other country, yet they fell short—and still do so—of the complete abolition of want which was the goal of the Beveridge proposals

The present British social services can be roughly classified under three heads (i) education, (ii) public health (including housing and health insurance) and (iii) income supplements, in the form of transfers in cash or kind from the incomes of other citizens, through the tax system These three headings now cover a large variety of services Under education, for instance, we should include the provision of schools and technical colleges, the payment of grants to certain schools, colleges and the universities, the payment of salaries to teachers and administrative staff, the award of scholarships and maintenance grants to pupils, the provision of ancillary services, school meals and medical service, and finally the provision of libraries, museums and picture galleries Considerably more than half education expenditure is, however, absorbed by the public elementary schools

The first public expenditure on health was in the provision of collective services such as street cleansing, sewerage and the provision of parks and baths [1] As the nineteenth century wore

[1] Many of these services are only loosely concerned with health, and it is probably more appropriate to class them (together with certain other services, such as the more cultural varieties of education expenditure) as "civic amenities" the development of which is an important indication of the wealth and enterprise of a locality, cf J R and U K Hicks, *Standards of Local Expenditure*

on, public medical services were widely provided for such unfortunate members of the community as paupers and lunatics, but there was no general personal health assistance by public authorities until the establishment of health insurance among other social reforms implemented by the Liberal government of the first decade of the present century Further services were established in the inter-war period for special cases such as maternity and the treatment of tuberculosis and venereal disease Finally the National Health Service with free (or highly subsidized) treatment for all according to their needs, and a national organization of hospitals, started operations in 1949 With these personal health services should be grouped the expenditure on nutritional foods, especially milk, distributed free to nursing mothers and children These started on any considerable scale only in the second world war, but have now become an established and most important part of public provision for the nation's health Of even greater importance than these during war time were the general food subsidies At their maximum these absorbed over £400 mn or 4 per cent of the national income As food became more plentiful they were gradually scaled down, but in 1953 outlay (as measured by the trading losses of the Ministry of Food) still amounted to almost £200 mn Although the general food subsidies were recognized as an effective method of underpinning the consumption of the very poor, they were a very costly method of doing so since most of the expenditure went to subsidize those who could well afford to pay market prices for their food

The remaining supplements to personal incomes are mainly given in the form of cash "grants to persons" Exceptions are the tea and tobacco cards of old-age pensioners, and rent and food vouchers which may be provided through national assistance Unemployment expenditure varies with the state of trade, but *per capita* payments have progressively approached the level of unskilled wages *Per capita* pensions payments also show a continuous tendency to rise, as well as a secular expansion due to the ageing of the population With the new social security system of 1948 additional benefits

became available, such as children's allowances and payments at marriage and death

During the 1930's the public social services (including war pensions, which have a similar social effect) required an annual outlay of about £500 mn Of this, roughly one-quarter went to education, one-quarter to health services (including housing expenditure not covered by borrowing), while the remaining half consisted of supplements to personal incomes (social transfers) of this, roughly half went on public assistance and unemployment payments, and half on pensions of various sorts Social expenditure had thus come to be more important as a provision of incomes than as a provision of services By 1953 total outlay on social services had risen to over £2,500 mn (a rise of roughly 350 per cent in real terms) Owing, however, to the high level of employment a smaller proportion represented supplements to personal incomes [1] The rise in pensions payments, however, was not far from making up the difference

Economic expenditure is the administrative and financial responsibility of the central government, but the local authorities have traditionally been Parliament's agents for the provision of the social services Since the extension of social security to the whole nation and the establishment of the National Health Service, however, central agencies have become directly responsible for more than 60 per cent of social expenditure For many years before this local services were heavily assisted by an elaborate system of exchequer grants, built up partly with a view to stimulating local activity, partly in order to make things easier for the less prosperous neighbourhoods We shall have to examine the policy implications of this apparatus at a later stage [2]

Adam Smith envisaged the "public works" comprising his "third duty" as being financially self-balancing, covering their costs out of sales and fees, and thus imposing no charge on the revenue This is roughly the position with the local trading

[1] See Chapter XVI, especially Section 4
[2] See Chapter XV, especially Sections 2 and 7

services and nationalized industries The postal services are, normally, operated to bring in a positive profit (totalling about £11 mn in the 1930's, but which since the war has fallen lower in real terms), this the Chancellor invariably regards as available in support of general revenue In the eighteenth century road expenditure was made self-balancing by the device of tolls, a similar result was in principle obtained in the inter-war period, during the independent life of the Road Fund (which came to an end in 1937), vehicle duties and fuel tax in principle being set against road expenditure In practice, however, the revenue collected was largely applied to general purposes The system of tolls is still much used in America, and there are strong arguments in its favour if it succeeds in getting roads built which would otherwise seem to throw too heavy a charge on the taxpayer, although in the end they would more than pay for themselves in increased speed of transport

The idea of making the social services self-supporting has long been abandoned Fees are indeed charged for a few services (e g for prescriptions and apparatus under the national health service), the house rents charged in the inter-war period by some authorities were almost sufficient to constitute housing a trading rather than a social service By and large, however, it is accepted that the social services should be provided free, in order to bring about a more equal distribution of consumers' incomes

The only type of public outlay which we have not yet discussed consists of payment of interest on the National Debt To the government this appears as just another demand on the public purse, absorbing revenue which might more usefully have been devoted to social or economic development This, however, is a misleading way of looking at the debt charge [1] In the first place the interest is not a burden on the revenue commensurate with the outlay required, because interest payments are subject to taxation Britain's high rates of

[1] For discussion of the economic significance of the National Debt, see Chapter XIX

surtax ensure that the national debt is self-supporting to a not negligible extent

A more important reason why we should not regard expenditure on debt interest in the same light as other forms of outlay lies in the nature of the loan The British National Debt is almost wholly a legacy from past wars In war-time the government borrows from the private sector, but when the war is over no tangible assets remain to set against the debt, nothing but paper claims from the debt holders against the government The National Debt is thus similar in kind to the consumption loans incurred by the spendthrift, which are set off against his income (if any) It is more logical to treat interest on the National Debt as negative public income rather than as a positive outlay, in any case it must be clearly distinguished from other sorts of public expenditure

§ 4 **The Changing Emphasis of Public Expenditure** It emerges from our discussion that Adam Smith's list of the "Duties of the Sovereign" is still not inappropriate as a classification of public expenditure In order to appreciate the importance of the public services in a modern economy it is necessary to give them a statistical content The relative importance of the different services is best realized by referring them not merely to each other but to the total resources of the community It is also necessary to have regard to their development over time, and to their variation with good and bad economic conditions Table I illustrates these movements by showing the relation of the main types of British public outlay to the national income[1] in the "normal" years (which are used as the bases of statistical series) 1913, 1924, 1938 and 1948, in a bad year 1932, and finally in 1950 and 1953

[1] The net national income, at factor cost here used, is not a wholly satisfactory measure of the output of resources since it contains an arbitrary element of depreciation of fixed equipment, but it is the only one available over the whole of our period The purist should note that social transfers are included with other social expenditure while they (with other transfers) are excluded from calculations of the national income in order to avoid double counting If we exclude them from social expenditure in 1953 its percentage would be reduced from 16 per cent to 7 per cent

TABLE I —THE MAIN TYPES OF BRITISH PUBLIC EXPENDITURE (ON CURRENT ACCOUNT) AS PERCENTAGES OF THE NATIONAL INCOME (AT FACTOR COST)

Year	Defence	Civil Government	Social Expenditure	Economic Expenditure: General	Economic Expenditure: Roads
	%	%	%	%	%
1913	3 6	0 9	5 5	0 006	1 0
1924	3 2	1 3	10 3	0 2	1 6
1932	3 1	1 7	15 8	0 5	1 9
1938	7 8	1 5	13 0	0 6	1 4
1948	7 5	3 0	14 0*	0 9	0 6
1950	6 9	3 0	14 0*	0 6	0 7
1953	9 0	3 0	16 0	0 4	0 5

* Including food subsidies, 18%

The dominance of social expenditure is strikingly demonstrated by this table, the greater importance of economic services than the expenditure suggests should, however, also be borne in mind In contrast to other economic expenditure road development has been allowed to stagnate, it can hardly be doubted that the neglect of the roads in the face of rapid expansion of motoring is an important factor in the high accident rate, which all deplore It is interesting to observe the very much higher level of defence expenditure in 1938 compared with 1913, and further, the extent to which the fear of a third world war has caused it to rise since 1950

It should be noted that all services registered an expansion relative to the national income, in the depression year 1932 This illustrates the rigidity of public outlay, due to the long-term arrangements under which most of the services operate The rising percentage does not, however, indicate an absolute expansion, except in the case of economic services and social expenditure, on the contrary, every effort was made to economize in order to balance the budget Even in the case of social expenditure the expansion was merely due to unemployment pay and public assistance, substantial cuts were attempted in other services, notably education By failing to distribute its normal quota of incomes the public sector thus contributed to intensifying the depression Fiscal perversity

of this nature in the public services is an important factor in policy, which we shall have to consider at a later stage [1] On the other hand the importance which economic and social expenditure had already attained in the inter-war period was in principle favourable to the implementation of a high employment policy, for which they are the most relevant factors

It will be seen that the expansion in the public sector which the table illustrates has been practically continuous throughout the inter-war period, it evidently does not depend on the dominance of any particular political party The community was just demanding, and getting, more public service in relation to private What is the significance of this? To an important degree the expansion was merely a consequence of the rise in the standard of living, public goods can be afforded more abundantly by wealthy communities Only when the most urgent individual wants have been satisfied will democratic majorities agree to the satisfaction of any but the most fundamental collective wants

There is, of course, another side to the matter Once an upward trend has been started it is easy and popular to vote an extension of public services when times are good, once a service is established it inevitably tends to grow Is there not a danger in this process that the community may, as it were inadvertently, provide itself with more public goods than it would really agree to if it could view the development over a period as a whole? The danger is not imaginary, but it can be guarded against in two ways In the first place an effective administrative machinery is required for the control of expenditure and as a check upon its efficiency, in the second place clear policy objectives must be developed and followed, in order to determine both the limits of wise expansion and the correct priorities between competing claims on the national resources We shall have to examine in turn the provision for these two controls [2]

[1] In Part III
[2] Cf Chapters IV and VI respectively, cf also Chapter XV

CHAPTER III

THE MAKING OF FINANCIAL POLICY

§ 1 **The Sovereignty of Parliament** Policy is proposed by the Cabinet, but must be agreed by Parliament before it can be implemented Our interest is not in the political forces which determine policy, but in the financial means adopted by Parliament to carry it into effect, including the policy which governs the choice of means Success in public finance depends on a judicious balance of stability and flexibility—stability because unnecessary change is costly and loosens the established threads of control, flexibility because in a world of change public finance needs to be kept appropriate to the situation We have to enquire how far these two qualities emerge from the financial apparatus which has been developed in Britain

All financial policy is ultimately under the control of Parliament, which has a final responsibility for the activities of every taxing and spending department in the country It is a principle of the British constitution that Parliament is in a legal sense all-powerful, but the immediate control of the House of Commons, even when the government has a large majority, is clearly much more limited

We can, in fact, distinguish three degrees of Parliamentary control over the public finances One part of public expenditure, and the balancing revenue, lies entirely outside the immediate jurisdiction of Parliament (being under the control of the local authorities), a second is reviewed by Parliament, but is agreed without debate, the remainder is submitted to Parliament in great detail and debated at considerable length It is obviously this third section which is most fully under control and most amenable to adjustment, but even then the hands of Parliament are to some extent tied by past contracts

and by the nature of the services Public finance never starts with a clean sheet any more than does the finance of any other "going concern"

It will be useful in the first place to discover the relative importance of these three degrees of Parliamentary control In the year 1953 the Cabinet presented to Parliament expenditure plans on current account amounting to £4,274 mn Revenue was planned to produce £4,368 mn, of which £4,177 mn was to come from taxes, leaving a planned surplus of £94 mn as a contribution towards investment or reduction of inflationary pressure [1] Of this expenditure total £674 mn was to be charged directly on the "Consolidated Fund",[2] that is to say it belonged to the second degree of control, to be reviewed, but not debated, by Parliament

The most important item in this section was the interest on the National Debt Once Parliament has agreed to the debt being incurred it must necessarily agree to the interest being paid The actual sum required can only be varied by a change in interest rates or by repaying part of the capital out of a budget surplus, there would therefore not be much point in Parliament discussing the debt charge The other items in this section are also fixed for long periods, either by contract or by design, they include payments to Northern Ireland under the settlement of 1922 and such matters as the household expenses of the Royal Family, pensions to retired citizens of note and salaries of certain officials (e g, the judges) whose tenure of office is independent of Parliament It is unlikely that Parliament would want to do anything about these, save in very exceptional circumstances

The remaining expenditure plan was divided into three parts, £1,365 mn for the supply of the defence services, £2,190 mn for civil expenditure and £45 mn to cover the cost of tax collection Detailed estimates of the distribution of the first two were submitted and duly discussed In principle all this expenditure came under the third degree of Parliamentary

[1] Cf the Balance Sheet on p 88

[2] For the significance of the Consolidated Fund cf pp 47, 48

control, it was within the power of any member to suggest a change of plan during the debates.[1] In fact, however, Parliament was pledged to pay over to the local authorities a sum of about £420 mn. from it, a much larger sum (about £950 mn.) was required to finance the various types of pensions, and to support the social insurance funds. In addition, it was estimated that over £440 mn. would be required to fulfil the undertakings of the National Health Service. Thus the freedom of action implied in the debates on the estimates, so far as these sums were concerned, was rather of the nature of a reminder to Parliament that it could if it liked take steps to alter the arrangements, than as having any relevance for the year in question.

In addition to their Parliamentary grants the authorities which thus received them collected taxes independently of Parliament (the local rate and contributions to social insurance respectively), to complete the financing of their activities. On the average, Parliamentary grants covered about 40 per cent of the expenditure of the local authorities on current account. Nearly 90 per cent of these grants were allocated to specific services whose conduct was broadly under the control of Ministers responsible to Parliament (such as the Minister of Education), the remainder was awarded as an "Equalization" grant in support of the general revenues of local authorities below the average in wealth, the local authorities themselves determined its distribution between services. Their policy was, however, inevitably deeply affected in the long run by the presence of these substantial grants.[2]

In a similar manner Parliament resigned control of the sums paid over to the national insurance fund. Its operations, however, followed "predestinate grooves" the broad lines of which had been laid down by Parliament, and could

[1] So long as the change did not involve a charge on public funds, see p. 51.

[2] The precise proportion of grants to independent resources, and of specific to block grants, differed considerably from one authority to another, but the degree of control by Ministers varied considerably less.

consequently be altered by legislation. Thus in practice the substantial sums paid over by Parliament to the local authorities and to the social security system passed out of current Parliamentary control, and belonged essentially only to the lowest order of control.

We may sum up the situation by saying that Parliament nominally controlled the outlay of about 80 per cent of the total current public expenditure, but at the most 30 per cent of this was subject to effective discussion. Of this, some part e.g., defence expenditure) was too technical to be usefully debated by laymen, and further parts were fixed by long-term engagements. These proportions exclude trading activities. On the other hand, about 85 per cent of the taxes collected was voted by Parliament. As compared with the 1938 situation the central government had extended its control more over expenditure than over taxation.

These proportions are, of course, substantially above those controlled by the central government of a federation, such as the United States. Moreover, the opportunities for flexibility are rather greater than appear. Greater adaptation to changes in the level of economic activity might be incorporated by statute into the policy of the social security system, and (less readily) by agreement into that of the local authorities. These are matters to which we shall have to return at a later stage (in Part III). On the whole, however, the British financial system is distinguished for stability rather than for flexibility. Substantial changes in public outlay, other than in defence expenditure, have been the result only of legislative changes.

Stability is not a merit in itself, but only so far as it conduces to the most effective distribution of public outlay. An examination of the machine which produces the annual plan of financial policy (loosely known as "The Budget") will enable us to estimate the probability of this.

§ 2 **The Treasury**. The centre of policy in the British system of government is the Treasury. In the later Middle Ages the habit grew up of giving the post of Treasurer to the chief

Minister of the Crown A very notable holder of the office was Lord Treasurer Burleigh, Queen Elizabeth I's great minister (the first of many members of the Cecil family to hold important office under the Crown) Since 1714 the Treasurer's office has always been "put into commission", i e a number of Lords Commissioners are appointed to form a nominal Board of Treasury to share between them the business of the office [1] This is for practical purposes a fiction, however, since like the Board of Trade (but unlike the Board of Admiralty) the Board of Treasury never meets The continued importance of the Treasury in policy is shown by the fact that the Prime Minister now always assumes the title of "First Lord of the Treasury" and the members of the Government are frequently referred to collectively as "the Treasury Bench"

The Chancellor of the Exchequer, the chief financial officer of the Crown, is the Second Lord of the Treasury His duties are to advise the Cabinet on financial matters, and to expound the government's financial policy in the House of Commons The most important occasion on which he does this is when he introduces the Budget,[2] the financial plan for the year, but other occasions on which an explanation by the Chancellor is called for are becoming increasingly frequent as the importance of public finance in the economy increases [3]

The Chancellor is now assisted by two Ministerial deputies Since December 1947, in addition to the Financial Secretary, there has been either a Minister of State for Economic Affairs, or an Economic Secretary Both advise the Chancellor on general financial and economic policy, but the Financial Secretary is responsible, under the Chancellor, for financial administration and procedure among other things, while the

[1] For the history of this device cf pp 47ff

[2] The first recorded use of the word in its technical sense appears to be in a pamphlet in 1733, cf Miss D M Gill, "The Treasury 1660–1714", *English Historical Review*, 1931

[3] The traditional function of the Exchequer—from which it derives its name—the tallying of tax collections, is now under the Department of Exchequer and Audit, presided over by the Comptroller and Auditor General, cf pp 50ff

Economic Secretary (or Minister of State) deals principally with overseas financial questions Other Treasury Ministers include the Parliamentary Secretary, who is assisted by five Junior Lords Commissioners, they are known as "Government Whips" and their duties are almost entirely political

Just as the First Lord is the central figure in the government, so the Treasury is the central department in the Civil Service Up to 1939 the Treasury was quite a small department, by far the smallest of the great Ministries, an officer in one branch was therefore able to know personally his colleagues in other branches and could consequently communicate directly with the officer he required Contrary to general belief, delays in obtaining Treasury rulings were not due to the red tape of a complicated hierarchy, but were an inevitable result of the difficulty of reaching decisions on matters of high policy

For many years the Treasury has been undergoing a gradual, but most significant, process of modification During the 1939–45 war there was a great extension of government intervention in economic affairs Much of the work of co-ordinating the war-time economic controls was carried out under the direction of the Lord President of the Council, or by other Ministries, while the Treasury duties were greatly increased as the scale of government expenditure grew and the problems of external finance became more pressing The Central Statistical Office[1] and the Economic Section were established in the Cabinet Office at the beginning of the war, and took part in the work of co-ordination organized under the Lord President For some time after the war the main responsibility for economic co-ordination continued to lie with the Lord President, but as the apparatus of direct controls over the economy was gradually dismantled, budgetary and monetary policy—traditional responsibilities of the Treasury—assumed increased importance as instruments of general economic policy In 1947 the Chancellor of the Exchequer added to his older functions the responsibility for general economic co-ordination At the same time the newly created Central Economic

[1] See below, pp 332ff

Planning Staff was transferred to the Treasury In 1953[1] the Economic Section of the Cabinet was also transferred to the Treasury

It will be seen from the above account that the Treasury has expanded its activities widely beyond its traditional role of financial watch-dog Although the necessity of organizing the economy for total war was the occasion of the great extension of the role of the Treasury, the changes of the post-war years are of even greater significance in the sense that they reflect a permanent reorientation in public opinion concerning the responsibility of the government for a national economic policy The stages in this process are reflected in the growth of Treasury personnel from some 400 at the beginning of 1940 to 800 at the end of the war and 1,350 at the beginning of 1950 From this position, it is safe to say, there can be no fundamental return Governments of different complexion may in the future lay more or less stress on the degree of control and planning they feel to be desirable In fact the dismantling of controls from 1951 has implied some reduction in Treasury personnel also These variations, however, are not likely to be more than minor, the policy which lies behind the new activities of the Treasury is a matter of public opinion rather than of party, and is accepted in principle by both the major parties

We shall be further concerned with these matters in Part III It is worth noting here, however, that even at its expanded figure the British Treasury is a small department compared with the central finance Departments of comparable countries This is because it is essentially a nucleus, co-ordinating the activities of a diverse collection of outlying agencies (such, for instance, as the Exchange Fund) By this means it has been found that the traditional advantages of direct communication and personal contact can substantially be retained even in the complicated circumstances of the present day

According to the new organization the Treasury is divided into five parts Supply, Establishments, Home Finance, Overseas Finance and Economic Affairs, corresponding to its

[1] For the significance of these changes, see below, pp 332ff

functions of watching over the activities of the other spending Departments, of supervising the general organization of the Civil Service, of preparing the details of internal financial policy, of dealing with external financial policy and of co-ordinating and formulating general economic policy.

The Supply Divisions of the Treasury discharge the traditional function of controlling expenditure other than on staffs. Each is responsible for a group of Departments whose financial activities it supervises, advising and helping on the preparation of Estimates and on the layout of expenditure. We shall have some more to say about this work presently.

The Establishments Divisions deal with all personnel questions relating to the Civil Service and the Armed Forces. Some control the numbers and grading of staff employed by individual departments. Others handle general questions such as pay, recruitment, manpower, policy and superannuation. It has become customary to refer to the senior officer of the Treasury (the permanent secretary) as the Head of the Civil Service, a title which is generally held to imply a policy of closer control and co-ordination than formerly existed.

The Home Finance Divisions are concerned with the preparation of the Budget, fiscal policy, the management of the National Debt, promotion of savings and banking and currency questions. They also cover the control of capital issues and the provisions of loans for local authorities.

The Overseas Finance Divisions fall into two groups. One is concerned with various general aspects of the balance of payments problem, such as export policy, import programmes, exchange control and so on. The other is concerned with the commercial and monetary relations between the United Kingdom and individual countries.

The sections of the Treasury dealing with general economic affairs comprise the Central Economic Planning Staff, the Overseas Co-ordination Section and the Economic Section. They are responsible for Economic Surveys and other general studies of economic trends at home and abroad. The Economic Section forms the staff of the Economic Adviser to

the government and is responsible for giving general advice on economic matters The Central Economic Staff and Overseas Co-ordination Section, which have more specifically administrative functions, are responsible for the co-ordination of various aspects of economic policy, particularly such as concern other economic departments besides the Treasury, this work includes the formulation of national investment policy, and the co-ordination of British policy in trade negotiations and in certain international economic organizations

§ 3 **The Annual Financial Routine.** The above comprises the main equipment for preparing financial policy By briefly following the annual routine of preparing the plans for expenditure and revenue, and passing them through Parliament, we can watch the machinery at work [1] The Financial Year in the United Kingdom begins on 1st April, formal financial preparations begin some six months in advance of its commencement, when (about 1st October) the Treasury sends to the various Departments a request for the submission of Estimates of expenditure for the coming year In actual fact this is not the beginning of the Estimates, which may almost be said to be in continuous preparation, as each item of expenditure takes place, minutes on it constitute the first stage in planning the corresponding item next year

The official opening of the financial, as of the Parliamentary, programme occurs on the reassembly of Parliament for the new session, an event which now takes place in the autumn At the opening of Parliament the Queen's Speech (prepared in the Cabinet and submitted to Her Majesty by the Home Secretary) briefly reviews the work of the session just concluded and outlines the business of the new session—the legislation which it is hoped to enact and a rough idea of the revenue which it will be necessary to raise, both to cover routine services and to provide for any new legislation which may have been passed in the previous session It is significant of the

[1] For further administrative detail cf Ivor Jennings *Parliament*, especially Chapter IX

British constitution that while the general policy plans are communicated to both Houses together, the Commons are addressed alone when it comes to matters of finance.

The Queen's Speech is followed by an Address from both Houses in reply to Her Majesty (this is also prepared by the Cabinet). The most significant thing about the Address is the opportunities which the debate gives—on the one hand for the Opposition to criticize the general policy of the government, on the other for the government to gauge the strength of the Opposition. When the Address is carried without amendment the government is in a very strong position.

At this stage in the financial year one further piece of routine machinery is set up. Expenditure and revenue debates do not take place as formal sittings in the House of Commons, with the Speaker in the Chair, instead they are conducted in Committee, but in Committee of the whole House, presided over by a specially elected Chairman. The same Chairman presides irrespective of whether the House is considering expenditure (when it is said to be in Committee of Supply) or taxation (when it is said to be in Committee of Ways and Means). At the time of the Debate on the Address these Committees are formally set up and their Chairman selected, although the machinery does not begin to function until some time later. The purpose of this rather odd Committee arrangement is to allow greater freedom in debate—for instance, as to the number of times a Member may speak on the same Motion—than would be permissible under the Standing Orders of the House when the Speaker is in the Chair.

The next stage in the financial year is the consideration of the Estimates by Parliament. These will have been submitted to the Treasury by the departments of the central government about mid-December, and provisionally approved by the Treasury before the end of January, they are brought before the House about the middle of February. The Supply Estimates are presented in a number of separate volumes for the Defence Departments, the Civil Service Departments and

the Revenue Departments respectively Together they occupy thousands of pages From the point of view of policy the Civil Estimates are the most interesting, since a large part of Defence expenditure is technical, and a further large part (e g, war-service pensions) is subject to long-term undertakings

The Defence Estimates are introduced to the House of Commons by the respective Ministers responsible for the departments, but the Financial Secretary to the Treasury undertakes much of the work of passing the Civil Estimates through the House of Commons The Estimates are grouped in "Classes" relating to the different Ministries—thus Class V is now entitled "Local Government and Planning, Housing, Health, Labour and National Insurance"—and covering the work of the respective Ministries Each Class is divided into a number of "Votes"—1, 2, 3, etc —these usually refer to the same type of expenditure every year, for convenience of checking outlay Each Vote is in turn divided into Heads, A, B, C, etc, and each Head into Subheads, A1, A2, A3, etc, so that the expenditure is finally broken down into quite small sums, occasionally as low as £10, more commonly in sums of £100 or so Thus the plan of the lay-out of intended expenditure is extremely detailed, but, as we shall see later, owing to the peculiar organization of public accounts, the details are in practice not very informative

A major responsibility of Parliament during the spring and early summer is the consideration of these Estimates, but Parliament also has a great deal of other business to attend to —new legislation, the discussion of current events and replies to Members' questions It has therefore been agreed that the Estimates can only be allowed twenty-six Parliamentary days[1] for consideration (with provision for three extra days if it proves absolutely unavoidable) These "Supply" days may be arranged almost any time that Parliament is sitting, between February and the end of July, when the Estimates must be

[1] The number was raised from 20 in November 1947 to allow time for the discussion of problems raised by the nationalized industries

passed Votes which have not been discussed by that date must be agreed to without debate [1]

By early April all the main transactions belonging to the previous financial year will have been completed, and the lines are clear for the new year's programme, formally ushered in by the Budget Speech On Budget Night the House is crowded, foreign diplomats, distinguished visitors and the Press are in their places in the galleries It is the great moment in the Chancellor's year, perhaps in his life He is photographed as he leaves home, clutching the fatal dispatch case which contains the jealously guarded secret of tax changes He may never be able to say "I hold in my hands war or peace", but the business world firmly believes that the case holds good or bad trade

Since the time of Pitt, Budget speeches have been among the most important made in Parliament In Victorian times, since the statistics were not printed, the speech was largely a *tour de force* illustrative of the Chancellor's memory, it might occupy several hours, and some Chancellors hardly deigned to make use of the notes provided for them by the Treasury, preferring to produce everything from their own heads Although there is now much more for a Chancellor to say in his speech, the process has been enormously shortened by making available to Members a printed Financial Statement summarizing both expenditure and revenue for the year which has just ended and the Estimates for the year just opening Even so, Chancellors are wont to make the most of their opportunity, and to attempt to give the speech an individual flavour in the tradition of a Peel or Gladstone, or even a Churchill or Snowden

We need not linger here over the plan of the Budget Speech, which invariably follows traditional lines, because we shall

[1] Certain other financial routine has also to be fitted in between the introduction of the Estimates and the end of March, concerned with the completion of transactions relating to the year then ending, and with interim arrangements for meeting bills during the four months of the new financial year which will elapse before the Budget becomes law The necessary legislation is embodied in two Consolidated Fund Acts These need not detain us, since no question of policy is involved

have to discuss at some length at a later stage the principles on which it is based The information given in respect of expenditure is inevitably very summary, since the accounting period will only have ended a couple of weeks earlier, and in fact it does not add a great deal to the weekly summaries of expenditure and revenue published throughout the year, consequently, this part of the speech does not arouse a great deal of interest The Budget properly so-called consists of the details of the taxes which it is proposed to levy during the year

This is what the business world has been waiting for The proposed tax changes will subsequently be debated in Committee of Ways and Means, it is not impossible that the government may have to modify some of the proposals during discussion, at least as to detail, but it is uncommon to meet strong opposition to considerable parts of the tax plan After all, Parliament already knows broadly what it is in for in the way of expenditure, and revenue must be voted to cover it In order to prevent forestalling of new taxes—for instance by laying in large stocks of a commodity which it is expected will be more heavily taxed—all the financial resolutions but one are taken immediately, if overpayment occurs as a result of subsequent amendment to the Budget, tax which has been paid is refunded This device secures at one and the same time continuity of revenue collection and opportunity for the discussion of tax changes

Since 1941 further statistical information of a very important nature concerning the country's finances has been made available to Members and to the public, at about the time of the Budget The important items of this are (i) the Economic Survey (which first appeared in 1947), setting out the nation's economic situation, both internal and external, as it appears to the government's statisticians and economists, (ii) the preliminary estimates of national income and expenditure (which since 1952 have been followed some months later by a "Blue Book" containing much more detailed and diverse information) and (iii) the account of the country's balance of payments with the rest of the world Increasing use of this economic information

is made by Chancellors in their budget speeches, and there is no doubt that they are leading to a much better understanding of the real economic situation and of the effect on it of public expenditure and taxation. We shall be further concerned with these matters in Part III.

Several days are usually allotted for the discussion of general economic policy after the Budget has been introduced. The House then goes back to general business, this time interspersing Ways and Means debates with the remaining supply days and other matters. When all the financial resolutions have been agreed to in Ways and Means, the Finance Bill is brought in and must be passed through all its stages before the end of July. It contains all the revenue changes, and from time to time a certain amount of general legislation concerning the details of tax administration.

Any of the Estimates which have not previously been passed are taken on the last two supply days, and passed *en bloc*, so that by the end of July the whole of the financial programme for the year will have been agreed to. It is embodied finally in only two Acts—the Finance Act covering taxation and all matters relating thereto; the Appropriation Act authorizing the application of revenue to the purposes stated in the Estimates. Thus, little more than four months after the opening of the financial year, all the vital arrangements for its transactions will normally be complete.

It will have been noticed that we have been concerned so far only with the activities of the House of Commons; before the Finance and Appropriation Acts become law they must also be passed by the House of Lords and receive the Royal Assent. There is now no danger of any serious hitch in the Lords, and the Royal Assent is completely automatic. The last occasion on which the Lords attempted to assert an independent policy occurred in 1909, when the Upper House refused to pass the Finance Bill authorizing revenue for the new social insurance funds. The Lords' opposition was recognized to be against the social rather than the financial policy in question, so that an important constitutional issue was involved. As a result

of this attempt to frustrate the policy of the government, the Lords were eventually forced to accept the Parliament Act of 1911, whereby a Money Bill, passed by the Commons and presented to the Lords at least a month before the end of the session, becomes law, whether the Lords agree to it or not

A simplified version of the Budget technique is followed by the more important Local Authorities, the Finance Committee usually playing a more or less parallel role to the Treasury in the preparation and co-ordination of the estimates of the different Committees of the Council Thus for each main public body in the country, the year's financial plan comes before the elected representatives of the citizens in a single, fairly simple, consolidated account

The consolidated account is an essential first step in ensuring an efficient lay-out of resources on the one hand, and an efficient control of expenditure on the other, but it is clearly no more than a first step, in itself it is no guarantee of efficiency in either direction We have only to consider what sort of control can be exercised by a Committee of more than 600 members which only allows itself twenty-six days to consider thousands of pages of estimates That it cannot be a control of technical detail is quite evident, it is hard to believe that even the broad lines of policy are really clear to many Members It is therefore not surprising that Parliament has been occupied for centuries in devising means of checking its own financial actions

CHAPTER IV

THE CONTROL OF EXPENDITURE

§ 1 **The Consolidation of the Public Accounts** The financial plan which is embodied in the annual Appropriation Act and Finance Act is the joint product of the Treasury, the Cabinet and Parliament (putting the partners more or less in the order in which their contributions are made) This co-operation is necessary, first, to see that the plan *as submitted to Parliament* is satisfactory, in that it provides for an efficient transfer of private resources to the public sector and for their distribution in accordance with the government's policy, secondly, that the plan *as it leaves* the House of Commons really expresses the wishes of the House, and, thirdly, that the plan is *put into execution* in accordance with the decisions of Parliament

These three conditions need to be distinguished, but they must all three be fulfilled A not-so-good measure proposed to Parliament may be improved as it passes through the House, on the other hand an initially coherent measure may be torn to pieces or distorted beyond recognition by bright ideas during debate, unless some means of ensuring self-restraint are available Needless to say even good measures will fail unless carried out according to intention

The three conditions just set out are not peculiar to financial measures, they are necessary for the carrying out of any legislation, and to discuss them fully would take us far away from the field of public finance, but they have an especial meaning and importance as applied to financial plans An inefficient piece of general legislation (say, an Education Act) will retard development in that particular line, but it will only in a minor way affect the general situation, an inefficient finance plan may upset the whole of policy and inflict harm on the entire economy, consequently, special measures have to be

taken to see that the three conditions are fulfilled in respect of financial measures

Parliament, as the ultimate authority, has to do its best to assure itself that the three conditions are faithfully carried out, but by its very nature it works under a grave disability For Parliament is essentially a dual-purpose assembly On the one hand it is a legislative body in control of the executive, charged with the making of new laws and with the duty of seeing that existing laws are working in accordance with intention, on the other hand it is a forum for the discussion of national and international issues, and for the ventilation of private grievances Neither of these two duties can be dispensed with, or even markedly curtailed, without damaging our democratic institutions, but it is obvious that the pressure of the second duty severely limits the time available for the first, and so makes success more difficult When we further reflect that membership of Parliament is not a whole-time job, and that most members have their own businesses to attend to, the importance of the time factor becomes still more apparent

For these reasons Parliament has found that it is desirable to have the financial plan presented in as simple and unified a form as possible, even so it has to rely heavily on the work of its partners It is worth pausing for a moment to observe the process by which the modern partnership and division of functions have been evolved, more especially the process of the consolidation of the accounts

It now seems clear that not merely the Cabinet (whose evolution is related in every school history book), but also the Treasury and the organization of the national finances were started in their modern careers as the result of a series of vital, but very inconspicuous, developments which took place between the accession of Charles II and the death of Queen Anne It is interesting to reflect that if the Pilgrim Fathers had sailed a couple of generations later these changes might conceivably have been embodied in the United States constitution, which would then probably have assumed a considerably different form from the one which it has now developed

In early Stuart times the "Executive" consisted of the "King in Council", that is to say, the King's advisers were outside Parliament, in the manner of the Executive of the United States The Treasury as a body emerged from this set up when Charles II departmentalized[1] the executive, with the double purpose of making it more effective and at the same time more obedient to his will Under a succession of extremely able officers, chosen for their financial and business abilities,[2] and under the guidance of Lord Godolphin, who held the supreme financial post under the Crown in many ministries and during four reigns, the Treasury soon attained the leading position among the departments Decisions came to be taken there, the old-fashioned Council found itself effectively by-passed and gradually sank into insignificance When before the end of the seventeenth century the transfer of the King's Ministers to Parliament took place (and the Executive and Legislature were united as "The King in Parliament"), the Cabinet being a Committee of Heads of departments, the Head of the Treasury naturally became the leading Minister

From the Restoration the attempt to finance any considerable part of the public services out of the revenues of the Royal Estates had been abandoned (the inadequacy of these had been at the root of much of the trouble under Charles I) The support of the Royal Household and similar expenses were then put on a "Civil List", later merged in the Consolidated Fund At the extinction of the life revenues granted to Charles I and James II the whole of Supply Expenditure became dependent on Parliamentary grant It was then possible for the Treasury Lords to prepare Ministerial directions, corresponding to the modern Estimates, but already from

[1] Cf D M Gill, *op cit*

[2] Especially Sir George Downing, appointed Secretary to the Treasury, 1667, who gave his name to Downing St , from the fortune which he accumulated was founded two generations later, and by a series of accidents, Downing College, Cambridge At least equally important was Sir Wm Lowndes, after whom Lowndes Square is called, Treasury Clerk, 1679, secretary to the Treasury, 1695–1724, his family motto records his skill in devising "Ways and Means" of raising taxation See *Dict Nat Biog*

1667 the way had been prepared for this step by the insistence of the Treasury that the departments should furnish weekly accounts of their transactions with the Exchequer From this period also dates the distinction between the two financial functions of Parliament—on the one hand to "Appropriate" supplies, on the other to find adequate "Ways and Means" to cover the appropriations

The next considerable step forward in the consolidation of the public finances was the work of the younger Pitt He has rightly been called the Father of the Budget, because he introduced the practice of laying the whole financial year's programme before Parliament in a single whole—on the one hand the Estimates for all Departments, on the other the total revenue estimated to be required to cover them Pitt also laid the foundations of a consolidated accounting system, by finally transferring the accounts of all departments to the Bank of England Modern practice, whereby the Estimates of Expenditure, and of revenue changes, are each passed in a single Act, is essentially a development of Pitt's reforms, so too is the single Exchequer Account at the Bank of England (the bank balance of the Consolidated Fund), whereby all in-payments to the government, and all out-payments to and by Departments pass through the hands and are under the control of the Paymaster-General

These three forms of consolidation are of the greatest importance for the orderly conduct of the nation's finances The device of the Consolidated Fund enables the Treasury very simply to keep a watch over the departments, and makes it possible for the Cabinet to ascertain at any time roughly how things are going, simply by examining in- and out-payments of the Fund The single Finance Act goes a long way to ensure that Parliament will agree on the necessary taxes, and will do so in plenty of time For policy the single Appropriation Act is still more important, since it is the guarantee that Parliament has really had the opportunity of considering the entire annual lay-out of public funds as a whole

This degree of consolidation was not achieved without considerable difficulty The post of Paymaster-General was created in 1834, the single Finance and Appropriation Acts date from the 1860's, and were mainly the work of Gladstone, who ranks with Pitt and Godolphin as a financial administrator The improvements were due, however, as much to the determination of the Commons to prevent the Lords from spoiling their plan, by throwing out essential parts (which was easy so long as it was presented in instalments), as to any anxiety to review the plan as a whole

§ 2 **Departmental Control** For the routine supervision of the Executive, Parliament relies more than ever to-day on the Treasury The operation of Treasury control is a continuous day by day process, all proposals for expenditure on new services or extension of existing services requiring Treasury approval before they are put in hand The submission to, and detailed examination by, the Treasury of the annual Estimates serve to crystallize each Department's expenditure into a picture of twelve months' cash requirements, and thus superimpose on the "running" control a more sharply defined "short-term" control once a year The two forms of control are complementary in sanctioning any new expenditure the Treasury is mindful of its effect on the current year's budget, while the examination of a particular year's Estimate provides the opportunity for a comprehensive review of the whole of a Department's activities and the general trend of its expenditure

Most of the Civil Departments publish detailed annual reports which provide Parliament (and the public) with a further record of performance (the Reports of the Ministries of Labour and Education are particularly noteworthy) The Defence Estimates (in time of peace) are accompanied by eight-year comparisons of expenditure for different purposes, they also contain departmental reports similar to those of the civil ministries Treasury sanction is required for the application of savings on one Subhead of a Vote towards an excess on another Subhead of the same Vote (technically known as

virement) Any important alteration in the form of the Estimates would not be made unless agreement had been reached between the Treasury, the Estimates Committee and the Public Accounts Committee

A parallel system is used to check expenditure as it takes place The Department of Exchequer and Audit presided over by the Comptroller and Auditor-General keeps a substantial staff (over 300) of auditors continually at work on departmental business In respect of those departments which derive all their moneys from the Consolidated Fund, control is a simple matter, but some have additional in-payments—for instance, the court fees and fines collected by the police, the check is then more complicated All such "Appropriations-in-aid", as they are called, have to pass through the Paymaster-General, they cannot be retained in the departments In the same way unexpended balances of funds voted by Parliament have to be returned to the Paymaster-General at the end of the financial year [1]

The office of the Comptroller and Auditor-General emerged from a series of reforms extending from 1832 to the Gladstone era, the Auditor-General is an "officer" of the House of Commons, with status similar to that of a judge [2] His duties are to enforce the regulations which govern expenditure and to detect and report any waste or irregularity which occurs The

[1] The expenditure accounts of the British Government come out in three editions (i) The Financial Statement, issued with the Budget, (ii) The Finance Accounts, issued in the following autumn These two also contain details of revenue collected, national debt operations, accounts of the civil list, and sundry other accounts, they differ from each other mainly in detail, (iii) The Appropriation Accounts, issued some eighteen months later for the civil and defence supply departments, in which are recorded all adjustments between the Consolidated Fund and the Departments

[2] That is to say he can be removed only by petition of both Houses The Comptroller and Auditor-General is thus the ultimate guardian of the public purse (and not the Paymaster-General, who is a member of the Government) This was brought out very clearly in the financial controversy of 1909–11, when there was some little danger of a stoppage of the public services, since the Comptroller and Auditor-General would not have continued to authorize expenditure if Parliament had failed to pass a Budget The episode is excellently described in Sir A Chamberlain's *Politics from Inside*

expenditure accounts are drawn up in an exactly parallel arrangement of Votes, Heads and Subheads as the Estimates, whenever there is a discrepancy, however small, between supplies voted and sums disbursed, elaborate explanations are provided Important discrepancies are often commented upon in the Auditor-General's Report which prefaces the Appropriation Accounts

§ 3 **Parliamentary Control** The direct contribution of the House of Commons to the shaping of the financial plan is made in the debates of the Committees of Supply and Ways and Means The practice of the British constitution goes a long way to ensure that the plan will go through in a coherent form, and probably without major amendment Three safeguards make this result highly likely In the first place electoral practice (straight voting in single member constituencies) ensures a workable majority in nearly all situations, secondly, the government's powers of closure, especially the limitation of the supply days to twenty-six enable it to impose its will, thirdly, and most important of all, the government has a monopoly of the right to make proposals which would require additional taxation—and few expenditure proposals do not

The first form of the Standing Order (now S O 78)[1] on which this most important provision rests, dates from 1713 Unfortunately the state of Parliament's records in the seventeenth century make it impossible to discover its origin, but we may safely regard it as a further legacy from the great days of Godolphin and Lowndes It is completely effective in preventing either government back benchers, or members of the Opposition, from wrecking the balance of a financial plan by trying to go "one better" than the government, a habit

[1] In its present form, which dates from 1866, S O 78 reads "This House will receive no petition for any sum relating to the public service, or proceed upon any motion for a grant or charge upon public revenue, whether payable out of the Consolidated Fund or out of money to be provided by Parliament, unless recommended from the Crown" Cf Jennings, *op cit*, p 250

which is the source of endless trouble in countries which do not follow the British constitution in this respect

In theory the Debates in Committee should provide opportunity for the House to examine the Cabinet's proposals reasonably thoroughly On the expenditure side, as we have seen, the Estimates are drawn up in very great detail, so that there should be no dark corners in the government's policy On the revenue side it was formerly the custom to ensure adequate opportunities for debate even if no tax changes were proposed, by making the income tax and one other duty (usually that on tea) renewable only from year to year, the decisive factor now is the annuality of the income tax, without which the public services could not be carried on

In practice, however, the supply debates do not ensure that the House makes a thorough examination of the Estimates Apart from the overriding limitation of the time available, Parliament in effect uses the supply days for a different purpose The Votes of the Estimates are not examined in any systematic manner, instead the Vote to be debated on any day is determined by the Whips in consultation, with the Opposition exercising a final right in the choice of subject If the Opposition considers that the Government's dirty linen has been insufficiently exposed to public view by a single debate, it is open to it to return to the same Vote day after day, merely by avoiding a division on the Vote in question Thus in the 1920's the Ministry of Labour Vote was discussed again and again, in order to draw attention to the Government's failure to abolish unemployment

As a result of this practice it invariably happens that by the time the last two supply days come round, only a fraction of the Estimates will have been considered at all It is then necessary for the remaining two days to be spent by members walking in and out of the division lobbies, passing estimates which have never been discussed, and which they may not even have read This treatment of the Estimates is a striking example of the difficulties caused by the dual nature of Parliament

In point of fact it is doubtfully necessary or expedient for Parliament to attempt to examine the details of estimates which have already been very thoroughly examined by the Treasury, indeed, the fact that Parliament insists on having these details before it actually makes it more difficult to adopt an effective system of accounting for the public services On the other hand it is by no means certain that the method used is the most useful for securing the type of general debate on financial policy which should be Parliament's proper contribution to the plan

Parliament debates the Estimates piecemeal, Vote by Vote, members being able to raise any topic whatever concerned with the Department whose Vote is under consideration This traditional practice led to difficulties when it was desired to raise a subject common to a number of departments By an ingenious modification of procedure devised in 1942[1] this difficulty has now been surmounted The common subject it is desired to debate (for example wage policy in the public services) is named in the terms of the motion brought before the Committee of Supply with a token vote set against it There follows a list of the Votes of the particular departments concerned, with a token vote (of say £10) against each, the total of these being the figure appearing in the Motion Thus a notional common Estimate is produced which provides the necessary peg on which to hang a Committee debate

Parliament has long been conscious of the inadequacy in the control over the lay-out of public resources which can be exercised by Committees of the whole House, it has therefore attempted to supplement the debates by investigations of select committees of its own members The oldest of these is the Public Accounts Committee,[2] still another of the Gladstone reforms It is a committee of fifteen members, drawn from the different political parties roughly in proportion to their

[1] After Sir H Williams had drawn attention to the inadequacy of the existing procedure

[2] First appointed in 1861, it became a Standing Committee in the following year

representation in the House (in accordance with the usual practice for select committees) In order to ensure a critical attitude the chairman is a member of the Opposition, it is usual, and obviously convenient, to choose the Financial Secretary to the Treasury in the preceding government

The Reports of the Public Accounts Committee are considered by the House on a supply day, and most of the evidence is subsequently published The importance of the work of the Committee, however, does not lie so much in the attention which Parliament pays to its findings as in the examination of witnesses from the departments The procedure is for the chairman to sit at one side of the table, the Treasury representative at the other, with the representative of the victim department between them It is not surprising to find that the most important effect of the committee's work is considered to be the feeling of "wholesome dread" which it inspires in the departments

By means of the double check of the Department of Exchequer and Audit and the Public Accounts Committee, a high tradition of financial integrity and probity has been built up among public servants It can confidently be stated that no country in the world wastes less of its substance through malversation in the public services [1] All this is excellent so far as it goes, but its effectiveness as a check on the allocation of resources is severely limited in two ways In the first place to make a detailed examination of expenditure only after it has taken place is apt to be like shutting the stable door after the horse has escaped, in the second place the type of control over the Executive which Parliament secures by these methods seldom rises above a fairly elementary technical

[1] The audit arrangements of local authorities are different Generally, their accounts are audited by District Auditors appointed by the Ministry of Health (now the Ministry of Local Government and Housing) but parts of the accounts of a number of boroughs are audited by firms of accountants The Report of a Departmental Committee on the Accounts of Local Authorities published in 1907 (Cd 3614), pointed the way to the standardization of accountancy methods

plane [1] Waste of public money is likely to occur in more subtle ways than through the occasional dishonesty of minor Civil Servants

In order to meet the first of these difficulties Parliament has tried various plans to ensure a more thorough examination of expenditure by submitting programmes as well as accounts to select committees A Select Committee on the Estimates[2] was appointed for each of the Sessions 1912–14, and again from 1921 to 1939 There is general agreement that these early Estimates Committees were largely ineffective [3] They showed little initiative in developing a technique of investigation Moreover they attempted to examine the Estimates between their release by the Treasury and their consideration in Committee of Supply, a process for which there is no adequate interval Throughout further, they were hampered by the absence of a secretariat such as was provided for the Public Accounts Committee by the staff of the Department of Exchequer and Audit There is evidence, however,[4] of increasing effectiveness just before their appointment ceased on the outbreak of war in 1939

Ever since the Crimean War, the abnormal expenditure due to war has aroused Parliament to a realization of the need for special watchfulness Both in the Crimean and in the Boer Wars, Select Committees on National Expenditure were appointed, but their duties were conceived mainly in terms of

[1] Some years ago, however, the Comptroller and Auditor-General made history by detecting a flagrant piece of inefficient buying of telephone equipment by the Post Office This discovery may well have been due to the more effective method of accounting now used in some of the Trading Departments as compared with the Supply Departments, see p 56

[2] For an excellent summary history of these cf the Eleventh Report of the Select Committee on National Expenditure for the Session 1943–44, on which also see pp 57ff, also Chubb, *The Control of Public Expenditure*

[3] It would appear that the authors of the first committee entertained no very high hopes of it Sir A Chamberlain records (*op cit*, p 475) that during the debate which led to its establishment (April 1912) the Chancellor of the Exchequer (Lloyd George) leant across and said to him "I suppose you are going to oppose this I have a minute of yours here arguing strongly against it and I cannot say I differ from you" The minute referred to a similar suggestion in 1905

[4] Cf Chubb, *op cit*

detecting fraud in the execution of war contracts In the war of 1914–18, extraordinary as it may appear, no watch whatever was kept over expenditure (apart from the Public Accounts Committee) from 1914 when the Estimates Committee lapsed (owing to the suppression of the Estimates for security reasons) until 1917 A Select Committee on National Expenditure was then appointed, and re-appointed sessionally until 1920, which possessed much wider terms of reference than previous committees It was charged with three separate duties, first to examine current expenditure (of any type) and to report to Parliament on the possibility of economies consistent with policy, secondly, to examine and make recommendations on the form of the Public Accounts, and on the system of control within the departments and by the Treasury, thirdly to examine Parliamentary procedure in relation to Supply and Appropriation, with a view to making control more effective

The committee did stout work during its period of office, particularly in respect of the second item in its terms of reference In carrying out its duties it had found itself continually hampered by the want of an adequate departmental accounting system which enabled the costs of a department to be seen as a whole This question raises important issues in connection with the art of budgeting and we shall have to return to it at a later stage in our investigations [1] As a result of the Committee's protests and recommendations some improvement was made in the accounting system of the trading departments, especially the Post Office, but the main problem remained untouched, with the passing of the emergency, Parliament's will to further reform evaporated

The mistake of leaving the national finances unattended during war was not repeated in 1939, within four months of the outbreak of war a new Select Committee on National Expenditure was appointed, and continuously reappointed until 1945 The terms of reference were, however, narrower than in 1917, the Committee was empowered merely to examine current expenditure, and in respect only of "services directly

[1] Cf Chapter VI, Section 1, and Chapter XX, *passim*

connected with the war" In spite of these hampering restrictions—more hampering than they would have been in 1917 because of the more permanent nature of many war works, and their greater adaptability to civilian use—the Committee succeeded in taking a broader sweep in its investigations than any previous body It developed a useful technique of working through sub-committees which enabled it to save time, without endangering the co-ordination of its programme Above all it managed to break through the obstacles to examining subjects common to a number of departments, and issued reports on such subjects as contract procedure, design and supply of stores, competitive bidding for personnel and the elimination of waste generally

The Committee on Expenditure Arising out of the War was abruptly terminated at the close of hostilities, and a new Estimates Committee was appointed in its stead It was very soon evident that this was no mere reincarnation of earlier Estimates Committees, but rather the direct heir of the war-time Committee Firstly the new Committee continued the war-time device of working through sub-committees, obtaining sanction to expand its numbers to thirty-four to enable it to establish seven sub-committees (of which one is a "steering Committee" charged with the drawing up and allocation of programmes), the sub-committee system enables the Estimates Committee to make ten times as many investigations as the Public Accounts Committee Secondly it abandoned the attempt to examine the Estimates between the Treasury and the Committee of Supply, interpreting "Estimates" as synonymous with "current expenditure" Thirdly, it continued the practice of examining particular programmes or projects as a whole, rather than ploughing steadily through the Estimates of selected Departments Thus for the first time a sort of continuing check on expenditure was established at the legislative level

Although the new Estimates Committee is much more effective than its predecessors there are inherent difficulties in the examination of public expenditure "ex ante" which are not present in its examination "ex post" In the first place the

criticisms of the Public Accounts Committee carry weight because it is in a sense in the position of a tribunal, an ex ante Committee cannot attempt to play this role for fear of weakening the responsibility of the executive officers concerned There is a similar difficulty in respect of the relations of the Committee with the House of Commons a Select Committee must be extremely careful not to usurp Parliament's prerogative by pronouncing on policy, as can easily occur when the examination is directed to programmes which are still in process of being carried out

The new Estimates Committee has profited greatly through the provision by the Treasury of a secretariat and of an officer to service the two Financial Select Committees, but it is still at a disadvantage as compared with the Public Accounts Committee, since there has been no preliminary survey of the ground at the administrative level, such as the work of the Department of Exchequer and Audit in examining the Accounts There is thus no automatic source of Agenda for the Estimates Committee, as there is in the Report of the Comptroller and Auditor-General for the Public Accounts Committee In these circumstances it is much more difficult to ensure that the ground has been effectively covered

The work of these committees show that inefficient allocation of resources in the public service can be traced again and again to particular weaknesses These are intensified by the rough and tumble of war finance, but they are present none the less in more normal conditions It is therefore worth examining briefly one or two of the most common forms of waste emphasized by the committees

Overlapping of similar services supplied by different departments is one of the most potent causes of the community getting less than full value for its outlay The Committee on National Expenditure found many examples of this—four departments, for instance, were responsible for camouflage This is a problem which in normal times has had especial relevance to the work of the different committees of local authorities Notorious examples were the development of

poor law hospitals into auxiliary general hospitals, and the competitive provision of post-primary education by county authorities and by authorities for elementary education only This overlapping is a weakness which is likely to become considerably more prominent among central departments and nationalized industries as their functions are extended—for instance, into the field of direct provision of housing and related consumers' goods

Overlapping services are sometimes due to carelessness in initial planning, departmental functions and powers are insufficiently defined, and over-zealous officers extend the work of their departments in unforeseen ways Overlapping is often extremely hard to prevent, especially with developing services, since their ultimate status cannot easily be determined In all of this, additional statistical information is still required as a foundation of systematic planning There would also seem to be a place for permanent machinery to review, and if necessary to redistribute, departmental functions, once overlapping is shown to have occurred, without paying regard to established interests

Another frequent cause of waste, apparently endemic in the public services, is the penny-wise pound-foolish policy of stinting salaries and materials, and so getting less than the best value for a given expenditure One example of this frequently emphasized by the Committee on National Expenditure was the tendency for departments to entrust initial investigations to junior officers who were insufficiently qualified or experienced, the plan thus had a rickety foundation from the start There is often a hesitancy on the part of public departments to incur heavy initial expense, even when it is justified, partly no doubt this is a relic of the time when control meant cutting down, partly it probably arises from the fear that the representative bodies for whom they work will take alarm at a big bill with nothing tangible to show, and decree a change of policy before the project is complete

This difficulty is closely related to one of the commonest forms of waste—alterations of plan after the work has been

started Alterations may become necessary either because planning at the outset failed to take proper account of the relevant factors—this again is largely a statistical matter—or because circumstances change before the project is complete This latter consideration is especially important in war-time and is one of the main reasons why war-time expenditure cannot be closely controlled, but it should have very much less relevance to normal times Whenever a change of plan is made, direct waste is caused because expenses have been incurred for what is now useless, indirect waste is likely to follow because of the difficulty of checking costs and revising contracts, once the original agreement has been abandoned There is urgent need in these and related directions for much more thorough investigation than has yet been attempted [1]

§ 4 **A Comparison with American Practice** The merits and demerits of the British constitutional practice in respect of finance can best be appreciated by comparison British Parliamentary procedure has been widely (but not always wisely) imitated abroad The Dominions follow British practice so closely in many respects that comparisons between them and the mother country are less informative than might be expected It is a testimonial to the workability of the British system that it can be transplanted successfully into very different political and economic climates The most illuminating comparison is with the United States, since the American system has the same heritage and general background as the British, but has developed on independent lines The

[1] When dealing with the control of expenditure, reference should also be made to the work of *ad hoc* extra-Parliamentary Committees appointed in times of especial excitement In the inter war period the most important of these was the (May) Committee on National Expenditure, whose somewhat alarmist report on the state of the national finances in the summer of 1931 precipitated the withdrawal of foreign balances from London, which led to the collapse of the gold standard The work of such committees is, however, of only minor interest from the point of view of policy, since they are charged with "economy" in the narrow sense of cutting down expenditure, thus the terms of reference of the May Committee bade it make recommendations "for effecting forthwith all practicable and legitimate reductions in the National Expenditure"

American financial machinery now controls the largest public expenditure of any democracy in the world Essential parts of it date only from 1921, but it already functions with much of the prestige of tradition

Superficially the two nations make use of very similar financial machinery In the United States the Estimates are also discussed between the Executive and the departments some months (about eight) in advance of the end of the financial year (which runs from 1st July to 30th June) They are subsequently published in a volume of some hundreds of pages The President's Report on the State of the Union at the opening of the Congressional Session corresponds to the Queen's Speech The Budget contains expenditure estimates for the year, and a foreshadowing of the revenue which will be required to cover them, and is accompanied by an explanatory Budget Message from the President [1] Appropriation Committee meetings parallel British Supply Debates The detailed revenue estimates are debated in Committee of Ways and Means

Thus, the whole American procedure is plainly a relative of the British system, but identities of nomenclature conceal important differences of substance, apart from fundamental constitutional differences which affect the whole set-up The general upshot of these differences is that opportunities for investigation by members of the legislature are better than under the British system, but control over expenditure is less efficient, and the prospects of successful plan carrying very much worse

In the first place the procedure for the passing of the estimates of expenditure and revenue is less unified and concentrated in the United States than in Great Britain Instead of a single Appropriation Bill and a single Finance Bill, expenditure and taxation are gradually determined in a series of separate measures Moreover, neither of the main British safeguards against failure to pass the year's financial programme as planned is operative in America In the first place it is open to any member of Congress to propose (and carry)

[1] In 1946 for the first time these three were presented together

additions to expenditure or reductions in taxes, secondly, all financial arrangements must be agreed to separately by the Senate This may give rise to enormous delay and to no little friction The separate Appropriation Bills make it less easy for Congress to view the year's programme as a whole These differences tend to drag out the annual budget routine so that it is difficult to clear one year's transactions before the following year is well on its way, thus causing confusion in accounting and a consequent loosening of technical control

Far more important than these differences of procedure are those which arise from the fundamental American principle of the separation of the Legislature and the Executive The President is the head of the Executive and his residence, the White House, is also the centre of the Administration, having attached to it the important Departments of State, including the financial offices such as the Treasury and the Bureau of the Budget The President chooses his "Cabinet", but like himself the members are administrative officers Thus the Cabinet knows everything that is going on, but has no legislative rights On the basis of his administrative knowledge the President can indeed make suggestions to Congress as to what he thinks ought to be done—for instance, the Budget Message includes a request for a certain tax revenue—but he has no power to require Congress to follow his advice Congress on the other hand is charged with the duty of making laws, but has no certain means of finding out what the Administration is up to

A second although less significant difference also arises from the American passion for checks and balances Instead of a majority remaining in power so long, but only so long as it has the confidence of the Legislature, as happens in Britain, in America all three bodies, the President (and his Cabinet), the House of Representatives and the Senate, retire automatically at short periods and have to be re-elected The Presidential election occurs every four years, Congressional elections every two, but as only one-third of the Senators retires on each occasion, there is greater continuity in the Upper House than in the Lower Owing to this electoral system it may very

easily occur that towards the end of the Presidential term his party finds itself in a minority in one or both Houses In that case Congress will probably refuse to pass measures which have the President's support, and he may well refuse to give his consent to those passed by Congress A complete state of frustration and stalemate then supervenes, in which even the annual routine of the financial plan may be in danger, until fresh elections once more permit the wheels of government to revolve normally

Such a complete jamming of the machinery is fortunately rare, but even at the best of times provision for plan making and carrying is less watertight than in Britain Not only is the American "Cabinet" outside Congress, but within the House of Representatives there is nothing that corresponds at all closely to the British Cabinet The preparation and steering of Bills through Congress is entrusted to Standing Committees, both in the Lower House and in the Senate (the House Committees on Appropriations and on Ways and Means are examples of these) Membership of a committee depends primarily on seniority and not on interest for the measure in hand As a result of all these roundabout elements in the American system, ways of providing the public with fuller information—of the conduct of the Administration and of the measures before Congress—have inevitably grown up in a manner which is unknown in Britain

Thus in the first place the preparation of the American Estimates is not solely a departmental affair as it is in Britain The Bureau of the Budget conducts Hearings at which the departments present their case The Hearings are not public, but they are not absolutely secret, and in practice a good deal of what is going on leaks out and is discussed in the Press The Estimates are next considered in Public Hearings by the House Committee on Appropriations, after which the Bills are drafted and discussed by the Committee, and finally discussed on the floor of the House The practice in respect of Ways and Means is exactly parallel, and the whole procedure in each case is duplicated by the Senate

In respect of Appropriation Hearings and debates the Senate may set its machinery in motion while the House is still deliberating, but in respect of Ways and Means, in order that the Lower House should have the first word on tax issues (in accordance with British tradition), the Senate postpones its discussions until the House has completed its deliberations (This respect for its British heritage does not, of course, prevent the Senate from turning the House Bills inside out when it does receive them) If everything goes smoothly the whole process of Hearings, committee sessions and House discussion occupies some eight or nine weeks, but the time allowed for the final stage of discussion on the floor of the House is quite short, perhaps not more than a week

Secondly, in order that Congress may have a reliable guide for action, the Administration collects and publishes very much fuller information on the activities of the Executive than are available in Britain The Treasury Department issues an excellently complete Monthly Bulletin of public activity Most items are reported with a lag of only a few weeks The American Estimates are also more informative than the British, although perhaps not quite so detailed Opposite each item in the Budget Statement is a record of actual expenditure over a term of years, as well as the estimates for the year in progress and the year which is being planned for These details are, of course, available to the general public as well as to members of Congress

Finally, the Administration collects from the business community (by means of frequent censuses of production and other investigations) much fuller and more up-to-date information on economic activity than is available in Britain, even to the government planners This difference is as much due to the attitude of the business community as to the zeal of the Administration The situation in Britain has improved remarkably in recent years, but has not yet caught up with the American standard This is a matter with which we shall be concerned in Part III

It will be apparent from this brief survey, that the British and American systems are so to speak complementary, one is weak

where the other is strong, and vice versa In the United States, apart from fundamental difficulties arising from the principles of the constitution, which presumably are not amenable to alteration, at least in the near future, the most pressing need would appear to be for better contacts between Congress and the Executive, so that the Legislature is enabled to find out directly what the Administration is doing With the increased activity of the public sector inaugurated by the Roosevelt regime and extended in the war and post-war periods this has become a matter of urgency During the war period some improvement in this respect was almost inevitably made One example was the work of a Special Senate Committee appointed to investigate the National Defence Programme (the War Investigation Committee) which performed services corresponding to those of the British Committee on National Expenditure This Committee has been highly constructive, and by the employment of a large staff of expert statisticians and economists has exposed waste and inefficiency in many branches of the Administration Projects for more permanent contacts have been discussed,[1] but, as in Britain, reform becomes more difficult to achieve as control becomes a less pressing need The successful handling of the minor recession of 1953 gives ground for hope that *de facto* if not *de iure* a better understanding between Congress and the Executive for the implementation of a national economic policy has been reached

[1] Cf the Reports to Congress of the Hoover Commission on the Organization of the Executive Branch of the Government, especially the "Task Force" Reports (Appendices)

CHAPTER V

THE PUBLIC REVENUE

§ 1 **The British Tax Structure in 1938 and 1953** The revenue proposals which are presented in the Budget in April, and subsequently debated by the House in Committee of Ways and Means, are not an autonomous plan in the same sense as the estimates of expenditure The total revenue required is determined by the total bill to be met (which by that time will be more or less decided), its distribution between the different possible sorts of taxes has not usually aroused any burning political controversy On only two occasions in the inter-war period were politics deeply involved in revenue discussions—in 1924 when Snowden repealed the "breakfast table" duties in the interests of the working-class family, and in 1932 when Neville Chamberlain induced the House to return—after nearly ninety years—to a general protective tariff On the first of these occasions the loss to the revenue was a mere 2 per cent, on the second, although the initial difference was small, the eventual effect, even in crude terms of revenue collected, was quite substantial

Although party issues are not usually very influential in determining the choice of taxes, from the point of view of economic welfare it is most important that the right taxes should be chosen Economists have always recognized this, and throughout the nineteenth century it was this aspect of public finance which monopolized attention More recently, with the expansion of the public sector, other problems have thrust their heads up with urgent claims to attention, but we must not allow them to obscure the view of the fundamental tax issues Accordingly, we shall be occupied for most of the time in Part II with questions of the choice of taxes The

purpose of the present chapter is to serve as an introduction to that study by familiarizing us with the relative importance of the different taxes in current fiscal practice

Public authorities do not, of course, rely entirely on taxes for their finance, but in Britain the part played by other normal revenue sources (interest on investments and profits of trading services) has so far been negligible Borrowing—except for investment in capital goods—has been confined to emergency finance, so that it is with tax revenue that we are almost exclusively concerned in this chapter

It will be useful to examine the distribution of revenue between different taxes as it was in 1953 compared with a normal pre-war year (Chart I) A major war inevitably leaves an aftermath of enormously increased revenue requirements The interest on the new debt requires heavy taxes to cover it, and apart from that war, is a stimulus both to the development of the social services and to the enlargement of the functions of the public sector in other directions Apart from changes in the level of prices it was inevitable that post-war tax rates should settle nearer to the war-time than to the pre-war level

In the chart the distribution of revenue between the different sorts of taxes (the tax structure) is shown for the two years respectively This, of course, is not the only, nor even the most interesting, way in which we might arrange the revenue A more interesting arrangement would show how much of the revenue from each tax is derived from families in different economic circumstances It will be more satisfactory, however, to postpone an examination of this latter arrangement until we have discussed the relative merits of the different types of taxes, accordingly we shall return to it at the end of Part II

It will be seen from the chart that with the single exception of the purchase tax in 1953, the types of taxes used, and even broadly their relative importance, were very similar in the two years, although the totals are so very different This similarity is largely inevitable, because fiscal changes only come about slowly, and moreover, tax experiments are abnormally hard to carry through in war-time, with depleted administrative

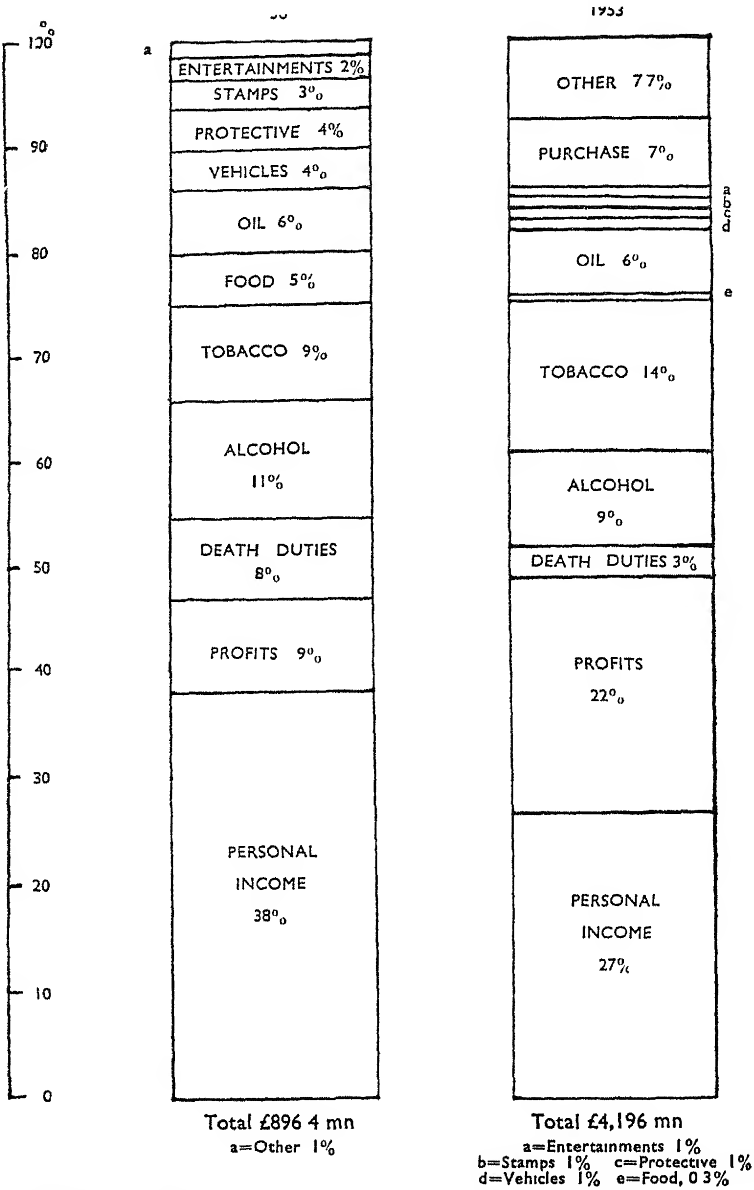

CHART 1 BUDGETARY TAX REVENUE IN THE U K 1938, 1953 (Percentage Distribution)

staffs It is thus very important to have a normal tax structure which will stand up to exceptional strain with only minor adjustments In the war of 1914–18 Britain had a decided advantage in this respect over both her Allies and her enemies, but owing to fiscal reforms abroad in the intervening years, her superiority in 1940 was less marked

In 1938 70 per cent of the revenue of the British national government was derived from only four groups of taxes[1] (i) personal (net) income tax, (ii) taxes on (net) business profits, (iii) duties on alcoholic liquors and (iv) duties on the consumption of tobacco In 1944 the proportion of the revenue due to these four groups had risen to over 85 per cent, E P T, the special war-time profits tax, was an important factor in this rise By 1953, however, these four groups of taxes were still contributing practically three-quarters of the central tax revenue This was accounted for by the continued high taxation of profits and personal incomes and by the conspicuous rise in the rates of tobacco tax

We must now turn to examine briefly the kinds of taxes of which the "rungs" in our "tax ladders" are composed The first three hang closely together, they are the taxes collected by the Inland Revenue Department[2] and constitute what are usually called "direct taxes"[3] What is important from the economic point of view is that liability to these taxes depends on the general economic position of the taxpayer, and not on the amount of his expenditure on particular commodities

In normal times the most important member of this group is the personal income tax, which although nominally two taxes (income tax and surtax) in practice forms one continuous

[1] For further details of the composition of the pre war British tax structure cf Shirras and Rostas, *The Burden of British Taxation*, and Barna, *The Redistribution of Incomes through Public Finance* For tax changes during the inter-war period cf U K Hicks, *The Finance of British Government*, cit, and since that period, *British Public Finances, their Structure and Development 1880–1952*

[2] So also are Stamp Duties and a few minor duties of which the most interesting is the seventeenth century Land Tax (cf p 121)

[3] For a discussion of the classification of taxes, see Chapter IX, Sect 1

levy on all incomes above a low minimum exemption limit [1] The personal income tax in Britain (and now in most other countries also) is the principal *progressive* tax, that is to say liability forms an increasingly larger proportion of large incomes than of small Death duties are also progressive—with the value of the estate—indeed in Britain they were the first progressive tax to be sanctioned by Parliament [2] They are paid when a property passes at death, and assessed directly on the value of total property owned by the deceased

In the years which we are considering there were two sorts of profits taxes in operation The first was the normal tax on the undistributed profits of firms, which is collected with the personal income tax as part of "Schedule D"[3], the second consisted of taxes on total net profits (before distribution) In 1938 only one of these latter, the National Defence Contribution (N D C) was in operation, it took a flat 5 per cent of the profits of industrial firms During the war, when "E P T " (Excess Profits Tax) was added, it and N D C operated alternatively, according as current profits were, or were not, in excess of normal earnings [4] After the withdrawal of E P T in December 1946, the N D C was retained as "Profits Tax" The rates were more than once increased and, in addition, a discrimination in favour of retained profits was introduced

At the height of the war, in 1944, five-sixths of the revenue derived from income and profits taxes came from profits or "impersonal income" By 1953 this proportion had substantially declined, but it is noteworthy that impersonal income continued to make a relatively higher contribution than before

[1] For details of the structure of British income tax, see Chapter XII, Section 2

[2] See Chapter VIII, Section 4

[3] "Profits from Businesses, Professions, etc " It is only from 1938 (with the issue of the White Papers on National Income and Expenditure) that the revenue from this tax can be separated from that of the personal income tax

[4] For the details of E P T cf Chapt XII, Section 4, and at greater length in *The Taxation of War Wealth*, by J R and U K Hicks and L Rostas

the war At a later stage we shall have to examine the economic implications of this change

The other taxes in the structure were traditionally designated ' indirect", with a few exceptions they are collected by the Board of Customs and Excise For the most part these taxes tend to be *regressive* with income, that is to say, the smaller the income, the larger the proportion which tax payments bear to it By far the most important of these taxes, which fall on particular ways of spending or holding wealth, are (as we have already noted) the taxes on the consumption of alcohol and tobacco Before the war the liquor duties group brought in the larger revenue of the two, but during the war this situation was reversed, a change which was consolidated by the rise in the rates of tobacco tax in the early post-war years In contrast, rates of taxes on drink have tended to be lowered rather than raised in recent years, due to falling demand In 1938 about 60 per cent of the liquor revenue was derived from beer, and nearly all the rest from whisky, in 1944 the beer proportion had risen to over 80 per cent, by 1953, with whisky once more available, the pre-war relation had been restored The immense tax potential of these groups of taxes was first exploited in the war of 1914–18,[1] since when rates of tax have many times been raised

In the 1930's, as will be seen, duties on food were by no means negligible, they were of three main types First came the time honoured taxes on tea and sugar, last relics of the "breakfast table" duties successively removed in the 1920's, in the second group were a number of duties imposed under the "Ottawa" Commonwealth agreements of 1932, typical of these were taxes on dried and canned fruit Finally there was a special kind of tax intended to boost wheat prices for the British farmer The wheat "levy" was collected from millers and paid over to farmers This last is not included in the chart since it fell outside the budget, a device adopted to spare it the darts of free trade criticism in Parliament

[1] But for the presence of Irish members at Westminster it is probable that the spirit duties would have been raised earlier

In the inter-war years most of the food duties had attached to them an "imperial preference" rebate, fixed on a specific basis, which implied that produce from the Dominions and Colonies enjoyed a substantial advantage in the British market As time went on the food duties also came to contain a growing element of protection for the British farmer The wheat levy was frankly designed for this purpose, it worked on a sliding scale, reminiscent of the old Corn Laws, and gradually faded out as the world price rose Even more interesting is the case of sugar In Victorian times this was wholly a tropical product and bore a straight revenue duty On the introduction of sugar beet as a British crop at the time of the first world war a demand for a subsidy arose In itself sugar beet is mainly a submarginal crop, but its merits as an item in an improved crop rotation on the one hand and as a strategic reserve on the other were so warmly pressed that it was deemed worthy of a high measure of protection cum subsidy The required subsidy had to be all the higher as the protective element in the customs duty became seriously eroded by imperial preference

In the post-war period the scene has substantially changed First of all the heavy subsidization of basic foods in the war period, and continuing through the reconstruction period, made such of the tax element as remained largely inoperative The importance of the specific duties progressively declined as the value of money fell, and this finally reduced the value of imperial preference almost to vanishing point Thirdly, to an increasing extent quantitative control (already growing in the 1930's) has come to take the place of protective duties, and guaranteed prices to British farmers of specific subsidies It is to these three elements that the substantial fall in the revenue from food duties is due Only in the case of sugar was a semblance of the pre-war situation retained Some of the substance of the old imperial preference is secured by a British guarantee, extending over a term of years, to buy a quota from all Commonwealth sources at a protected "negotiated" price, outside this quota a further amount qualifies for the remains of imperial preference, so that only marginal supplies need be

sold on unprotected world markets This system is mainly of benefit to certain West Indian islands whose basic crop is sugar Needless to say it has been found possible to work in a method of continuing to protect British beet sugar

The wheat levy is of some interest finally, as an example of a tax whose revenue is "earmarked" for a particular purpose, and is thus not available for general revenue needs The earmarked tax is an apparently plausible device, which in practice is very awkward Even if initially the funds are appropriate for the purpose, there is naturally no guarantee that they will continue to be so after a lapse of time Fortunately, this is now generally realized by British chancellors [1]

Next in importance come the taxes on motoring, in respect of which, in addition to the vehicle and driving licence duties, nearly the whole of the tax on hydrocarbon oils is collected Motorists—both private and commercial—are thus taxed by two methods, an "overhead" in respect of the type or category of the vehicle, and a "running cost" charge, according to the fuel consumed In every country motoring taxes are tending to provide an increasing source of revenue, and there is usually some such dichotomy of charge (which has a sound logical basis), but it is probable that in no country are the rates of both sorts of taxes so high as in Britain

Next in interest, although not in fiscal importance, are the remaining protective duties These fall into two groups, first the duties imposed in the early 'twenties, either for strategic reasons, or on such "infant industries" as rayon (a tax which for obvious reasons had to include silk), or motor cars and accessories [2], and secondly, those imposed on the advice of the Import Duties Advisory Board, established to implement the protectionist regime in 1932 Many of these protective duties are levied on the raw materials and semi-finished products of

[1] A notorious Victorian earmarking device was the "assigning" of certain revenues foi local government purposes—especially part of the receipts from liquor consumption (colloquially known as "whisky money") for the development of higher education

[2] Viz "McKenna" (1915), Key Industries (1921), Silk and Artificial Silk (1925), Duties (which include nylon and all similar fibres)

industry, and were originally designed to promote industrial recovery from the depression of 1931 While they undoubtedly helped the industries concerned, and thus raised the general level of employment, the policy behind them and the Ottawa Agreements first brought the British revenue authorities into definite conflict with other countries, particularly with the United States

We may pass very rapidly over the remaining normal Budget taxes Stamp duties are mainly collected on property transfers, especially of stock exchange securities, so that they attain considerable importance during stock exchange booms Other stamp duties are those levied by the 2*d* stamp on cheques and receipts Entertainments duty is payable on admission fees over 6*d*, and is graduated fairly steeply on the better seats

Of more interest than these is the war-time purchase tax, first imposed in 1940 with the primary purpose of limiting consumption In spite of the exemption of food and "utility" goods, and the scarcity of other commodities in war-time, purchase tax brought in a revenue of about £100 mn per annum during the war After the war this rapidly increased to about the level of £300 mn The principle behind the British purchase tax has all along been that as large an element of (relative) progression as possible should be embodied in it In the first place its coverage is highly selective, in particular all food and children's clothing have always been exempted Secondly the qualities of goods bought mainly by weekly wage earners have been very largely exempt, to start with under the "utility" scheme, which during the war and some time afterwards gave a guarantee of solid quality as well as of moderate price, since 1952 the so-called "D" scheme has been substituted for the utility system The characteristic of this is that goods under a certain price (fixed separately for each category) are exempt from duty, purchase tax being charged only on the excess over the "D" limit This, it will be seen, introduces a greater measure of progression than existed under the utility system Finally, by means of differential rates of tax (at one time ranging up to 100 per cent) an effort has been made to tax more heavily goods of a "luxury" nature In as

much as a luxury cannot satisfactorily be defined this element in the tax has worked with some peculiar results.[1] Differential rates have also been used, perhaps with more effect, to "steer" demand away from goods, such as electrical equipment, where it was especially urgent to curtail demand.

Taxes of the nature of British purchase tax (usually called sales taxes) are now a normal feature of the tax structure of most countries, but elsewhere their coverage tends to be wider and their rates lower than in Britain. Such taxes are especially attractive to the regional governments in a federation because of their superficial administrative simplicity and productive revenue. They are not, however, a good sort of tax in practice. They fall directly on family budgets, so that unless the coverage is very carefully controlled they tend to be very regressive. If they are imposed (as sales taxes) at the retail stage, collection is expensive and it is difficult to prevent evasion. On the other hand, if they are imposed at earlier stages in the process of production and distribution (as gross turnover or gross income taxes) the burden tends to be exaggerated through repeated "marking up" of price to cover tax at each stage, so that the ultimate weight on the consumer is exaggerated. These disadvantages must be set against certain theoretical advantages (which we shall have to examine in Chapter IX), which may be expected to accrue if the coverage is carefully chosen and the rates kept low. They imply that in normal times, when the tax is not required to fight an inflationary pressure they should be used only very moderately.

All the taxes (except the wheat levy) which we have so far discussed are budgetary taxes, but there are also two other important members of the British tax structure of which we must take notice—the "rate" levied by local authorities on the occupiers of buildings and land (other than agricultural land), and contributions to social insurance.[2] The fiscal importance

[1] Thus picture postcards bear the maximum rate.

[2] The net revenue of the Post Office is also sometimes regarded as a tax, the question turns upon how far it should be regarded as the normal profit of a trading service, or as a monopoly charge. Chancellors, as we have seen, appear to regard it simply as a tax.

of the local rate has long been declining relatively to the revenue of the central government, but it is still a very important tax, with a yield second only to income tax (£211 mn in 1938 and £436 mn in 1953), some 60 per cent of the revenue comes from domestic property, and most of the rest from shops and offices, since factories were excused three-quarters of their liability under the Local Government Act of 1929[1] At a later stage we shall have to devote a good deal of attention to this tax, since it is the pillar of local government finance[2]

From the inception of the services, social insurance in Britain has been financed by a tripartite arrangement of contributions from employers, beneficiaries and the general revenue, the contributions being paid at first into a separate fund for each service With the extension of the social security system to the whole nation (by the National Insurance Act 1946) the separate funds were consolidated into one There is undoubtedly a genuine "insurance" element in the beneficiaries' contribution, and this has led some people to question whether it should be regarded as a tax, the compulsory nature of the payment, however, determines that economically it must be so classed We should thus call the beneficiaries' contribution a poll tax, that is to say, an equal per head levy, at rates which vary only with sex, and to some extent with age The employers' contribution is related to other taxes on factors (e g, the tax on petrol used in industry)

§ 2 International Comparisons of Tax Structure How does the British tax structure compare with those of other countries? Such comparisons need to be made with great circumspection It is often misleading, for instance, to compare rates of tax, because the degree of evasion and the scope of exemptions differ enormously from one country to another Even a straightforward comparison of *per capita* revenue may be

[1] At the same date agricultural land, which had already been partially "derated" at earlier periods, was excused the whole of its remaining liability

[2] See Chapter XV, *passim*

misleading, taxes which are nominally similar may be very different according to the type of economic and social milieu in which they operate For instance, taxes are called income taxes which are very different from the British idea of a highly progressive levy, minutely adjusted to the taxpayer's position, and which are, in fact, no more than a flat proportion taken from each taxpayer, based on a rough estimate of his income made by the revenue authorities, without any reference to the taxpayer himself Again taxes are called "general property taxes" which are in no sense taxes on total property (or capital) as British death duties are, but are, in fact, almost wholly taxes on land and buildings, and are thus more akin to the British local rate [1]

The most interesting international comparison is once again with the United States—both for its similarities and for its contrasts Just as in respect of budgetary practice, starting from a common origin, the two countries have developed on broadly parallel lines, but in fiscal policy there have been two major differences Firstly, the United States has traditionally been a highly protectionist country, secondly, the fact that its constitution is federal and not unitary causes a substantially different distribution of resources between major (federal) and minor (state and local) governments from what we have found in Britain

Traditionally its monopoly hold on customs revenue was the mainstay of federal finance, the Ways and Means Committee of Congress is still regarded as primarily an instrument for the adjustment of the tariff Federal income tax first became permanently established in 1913, since that time the federal taxation of income and profits has enormously increased, largely catching up with British rates of tax during the second world war Owing to the recent expansion of the income taxes in the United States, and to the readoption of protection in the United Kingdom, the tax structures of the two countries are now a good deal more like each other than they used to be

[1] For instance the local property tax in the United States

Table II compares the distribution between sources of the total tax revenue in the two countries in 1938 and 1953 The U S A has traditionally been a low tax country, but of recent years its revenue needs have been expanding rapidly In 1953 at 25 per cent of the gross national product, the tax revenue was still substantially below the British level, but it was gradually overhauling it The lower level of taxation in the U S A is essentially due to the fact that the social services are still less developed than in the U K , but since the end of the second world war there has been a rapid expansion and this will no doubt continue

TABLE II PERCENTAGE OF TOTAL TAX REVENUE DERIVED FROM DIFFERENT SOURCES 1938 AND 1953

	U S A		U K	
	1938 %	1953 %	1938 %	1953 %
Customs and Excise, Sales (less motor fuel)	21	14	24	29
Personal Income Tax	10	36	32	23
Profits Taxes	12	24	7	19
Gift and Inheritance (capital taxes)	4	1	6	3
Motoring (Fuel and Licence)	10	4	7	7
Social Insurance	10	6	5	10
Property (Rates)	32	10	17	8
Other	1	5	2	1
	100	100	100	100

Comparing the total position of the revenue in the two countries, the two most striking changes which are common to both countries are the rise in the taxation of profits relative to personal incomes on the one hand and on the other the decline in the importance of the local rate and its American counterpart the (almost completely local) tax on property, the greater part of the revenue from which is derived from land and buildings The first of these changes can be regarded as to some extent a relic of the war, when in both countries excess profits taxes carried the taxation of profits to very high levels, the necessities of the Korean war implied that profits taxes

should remain high, while the continued high level of economic activity ensured that this could be done without too serious economic repercussions The decline of the local tax on land and buildings is in both countries related to the stickiness of land values relative to other prices in a period of inflation, and the consequent difficulty of keeping valuations in line with true values In the U K this difficulty has been exaggerated by the persistence of rent control and the inability of any administration so far to devise a system of valuation which would reconcile post-war values with pre-war rents

Comparing the changes in the two countries, those in the U S A are clearly dominated by the great rise in the importance of income and profits taxes, this is a most interesting development On the other hand in the U K these taxes, after dominating the tax structure during the war, have become less important relatively to taxes on outlay In both countries these trends have continued over the most recent years, the 1950 figures would tell the same story but in a less accentuated manner One underlying cause of the now relatively small taxation of outlay in the U S A is that, in spite of some very high rates of duty, the American tariff does not bring in a very large revenue, because the volume and range of imported goods are alike low, especially of finished goods Another relevant difference is the extremely high taxation of tobacco in the U K Even if the Americans wished to tax smoking as heavily as the British they would run into formidable technical difficulties, due to the great importance of domestic tobacco growing

Table III compares in somewhat more summary form the changes in the sources of the different layers of government, and also the change in the central share of each source, in the U K there has of course been no change in this respect The extent to which the U S federal government has been gaining on the rest is most significant, and once again the movement is continuing, in 1950 the share of the federal government had not yet reached 70 per cent That this is mainly due to the growth of income and profit taxes is clear, and here again the trend is unbroken It is also significant that as social

TABLE III RELATIVE TAX RESOURCES OF DIFFERENT LAYERS OF GOVERNMENT, U S A AND U K 1938, 1953

Tax	USA								UK			
	% of Revenue accruing to Federal Government		% Distribution of Tax Revenue between Sources						% Distribution of Tax Revenue between Sources			
			Federal		State		City & Local		Central		Local	
	1938	1953	1938	1953	1938	1953	1938	1953	1938	1953	1938	1953
Customs, Excise, Sales												
Alcohol and Tobacco	77	70	18	4	7	5	7	neg	22	22	—	—
Other	21	20	10	8	19	22	6 0	6	10	10	—	—
Motoring (fuel and licence)	19	23	5	2	31	28	6	neg	9	7	—	—
Personal Income, Profits, Gift, Inheritance	80	96	53	77	18	17	—	neg	49	48	—	—
Land, Buildings and Property	—	—	—	—	6	3	92	89	—	—	100	100
Social Insurance	51	77	12	7	18	11	—	—	10	12	—	—
Other	31	42	2	2	1	15	7	6	neg	1	—	—
TOTAL	46	76	100	100	100	100	100	100	100	100	100	100

expenditure rises the federal share of the revenue, through social security contributions, also rises With a few notable exceptions the federal government has traditionally been more active than the states in this sphere

Turning to sources of state revenue, it will be seen that the three major sources remain, as they were before the war, excises (in practice sales taxes), motoring taxes and income and profit taxes Of these the income and profit taxes lost some ground during the war on the one hand state treasuries were well supplied relative to the expenditure they could undertake, on the other federal income and profit taxes (which usually rank as a cost for state assessments) were so high that the revenue from state income taxes was low and uncertain On this account there was during the war some slight decline in the competitive exploitation of the same tax sources by different layers of government—always a difficult problem in a federation

This position has been reversed in the most recent years and the trend appears to be moving in the opposite direction Hard pressed by the fall in property tax revenue on the one hand and the rising costs of social services, especially education, on the other, cities in some states have also been permitted to raise local income taxes, in other states they are now engaged in knocking at the doors of federal constitutions for enabling powers As things stand at present, however, the changes in the distribution of local revenue sources as compared with pre-war have been minor The most interesting feature is the expansion of miscellaneous sources, such as parking meters, licences and other small taxes, this is in itself a reflection of the financial stringency in which many American cities are now finding themselves

Taking all in all, however, the dominating feature in both countries has been the growth in the public sector, as reflected by the rise in tax revenue relative to the gross national product, and with it the concentration of influence in the hands of the central government The significance of this development for the success of a national policy of economic stability hardly needs emphasizing

Tax structures broadly similar to those of Britain and the United States are now to be found in most advanced and industrialized countries Income taxes with some considerable degree of progression are now almost universal, although the majority date only from the 1914–18 period [1] Heavy reliance on the taxation of alcohol and tobacco is also very common, although in no country do both sources appear to be so heavily exploited as in Britain Britain also makes more use of motoring taxes, and as we have seen of inheritance taxes, than other countries More backward countries have to rely heavily on customs duties, although recently many of them have been experimenting with income taxes Such countries are always at a disadvantage in an emergency since the revenue is much less flexible than one largely derived from income taxes Finally, for local purposes, the use of a tax on land and buildings is very common Although this is an ancient and rather a primitive sort of tax, it has, as we shall see later, a number of conveniences for purely local use [2]

§ 3 **Other Sources of Revenue** In normal times the only alternative source of public revenue for current needs has been income from public property including trading services and interest on loans and investments In Britain, at first owing to the small amount of public property, later to the price and output policy followed in the socialized industries this source has provided only a very modest supplement to taxation In 1938 the national government derived an income of only £17 mn from its property, by 1953 this had risen to £188 mn, but over 70 per cent was composed of interest on past loans (many of them to authorities overseas) In 1938 the property income of local authorities amounted to £26 mn, of which £16 mn was due to interest on the investment of reserves and pensions funds, and to rents on municipal estates, so that the profits of trading services made a very small contribution

[1] Since the war the U N organizations E C E, E C L A and E C A F E have published some useful comparative tax statistics

[2] Cf Chapter XV, Section 5

indeed By 1953, consequent on the nationalization of the major local trading services the *net*[1] revenue must have been still less

The slight use of trading profits as a source of revenue in Britain as compared with some other countries (notably Sweden) is largely to be explained by the nature of the industries which have been socialized

In industries which have an inherent tendency towards monopoly, such as fuel, power and transport, there has been a natural reluctance to extract a monopoly profit from consumers Indeed the desire to avoid such exploitation has been an important factor in determining nationalization

The third source of public finance in 1938 was borrowing by the central government, but this was entirely due to the fear of imminent war Except for emergencies such as war, public borrowing by British governing bodies has been restricted to the needs of long-term investment When faced with serious emergencies central governments have always borrowed freely, they have the right to do so whenever the requirements of public expenditure exceed what can reasonably be expected from the income of the citizens, and they can borrow quite safely because they have unlimited tax powers, so that (unless there is a danger of a revolution) the means to service the debt can always be found, and in the last resort they can avoid national bankruptcy by depreciating the currency In respect of minor governments (the local authorities or the constituent states of a federation) the position is substantially different For them to borrow freely for current needs, however urgent, may put them in danger of bankruptcy, a situation which should never be allowed to arise[2]

The advantages of borrowing to finance long-term investment have also generally been recognized in the past By means of loan finance the equipment can be enjoyed by the community at a much earlier date than if it had to be paid for out of current income British local authorities have

[1] Not given separately in *National Income and Expenditure*
[2] Cf p 237

sometimes made less use than they might of these advantages, through concentrating on the additional cost of the loan interest, rather than on the additional benefit of the earlier investment This is a question which we must discuss at a later stage In the past the borrowing of the British government for investment purposes has been practically confined to the Post Office services, apart from the activities of the Public Works Loans Board,[1] which is really engaged in financing local investment

The restrained borrowing policy of the British government in the past has on the whole been sound sense A central government which abuses its powers by allowing casual Budget deficits to develop in normal times runs the danger of seriously weakening the technical control of expenditure, and opens the door to all sorts of abuses in the civil service If the government is also unable to control the monetary situation, it runs the danger of heaping up a burden of debt interest which may chronically embarrass the Budget, and lead to an impasse which requires a repeated depreciation of the currency French fiscal history since the Napoleonic wars furnishes several examples of the evils of this rake's progress

Under modern conditions the situation is substantially different It is now realized that in times of under-employment the most effective way of sustaining the national income is for the government to spend more than it taxes, thus effectively borrowing, while in times of full employment and inflationary pressure it should tax more than it spends With the new technique of national income accounting, the *compensatory finance* of the government, exercised through budget deficits or surpluses, has become an important instrument of policy Borrowing up to the amount required for national balance is correct policy which need cause no alarm These are matters which we shall have to discuss at length in Part III

[1] Cf Chapter XV, Section 5

CHAPTER VI

THE BALANCE SHEET OF THE PUBLIC SECTOR

§ 1 **The Budget Accounts and Their Significance** Now that we have looked at the way in which the State distributes its resources over different services on the one hand, and gets command over the necessary funds on the other, the next step is to consider the two sides of the account together in the form of a complete budget "The Budget" usually so-called is, as we have seen, the account of the activities of the central government, presented by the Chancellor of the Exchequer on Budget Night It is, of course, not a complete account of the public sector of the economy In the inter-war period it came short of covering the total expenditure of public authorities on current account by about a third By 1953, however, it had risen to about four-fifths The Budget is concerned primarily with outlay on current account, and with the revenue to cover it Certain capital items are, however, given in an annexed table of the "Financial Statement" set apart "below the line" [1]

In considering the accounts of the whole public sector we have to include as well two other sets of budgets—those of the social insurance system on the one hand, and of the local authorities on the other Of the latter there are in all about 1,300, but for most practical purposes it is sufficient to take into account the activities of the eighty-three county boroughs and the sixty-one statutory counties in England and Wales, and the parallel bodies in Scotland and Northern Ireland, because a great part of the activities of the smaller county authorities are effectively controlled by the county councils

Even with these simplifications it is evident that it is a complicated business to put together an account of the entire

[1] For the significance of this see below p 348

public sector A few years ago it was only possible to do so rather roughly, and after a lag of about two years from the period to which the accounts related This was obviously much too late to be of any relevance for the direction of policy With the beginning of the series of Estimates of the National Income and Expenditure (the first of which, it will be remembered, was presented with the Budget of 1941), the situation has been greatly improved We now have not merely better accounts for the public sector, but also an account of the whole economy (which, as we shall see later, is of first rate importance for the direction of policy) It is still necessary, however, to wait for several years before the details of the activities of local authorities are available

The Chancellor's Budget is confined strictly to the accounts of the year just ended and the estimates for the year just beginning, although the Financial Statement also contains a list of total expenditure and total revenue collected over a series of years The general accounts of local authorities are not kept on any uniform plan (from which it follows incidentally that the returns which they make to the central government are also not very uniform) There is no opportunity of examining local estimates except in so far as individual councils may choose to give them publicity in the local press

The traditional reason for the central government's lack of knowledge of the intentions of the local authorities is, of course, that their spending plans are to a considerable extent their own affair, and in the local rate they possess an independent source of revenue which enables them to some extent at least to give expression to their individual preferences The budget of the central government is, however, linked to the budgets of the local authorities by means of the exchequer grants from which a considerable part of their expenditure is financed In a similar manner the budget of the central government is linked with the budget of the National Insurance Fund, by means of the exchequer contribution to the fund

In order to find our way about the public accounts it will be convenient to start with the Chancellor's Budget, from that

(with the help of the National Income Estimates), we can proceed to the "balance sheet" of the whole public sector. Finally, again with the aid of the Estimates, we can extend the account to the whole economy We shall thus have an opportunity of comparing the relative magnitude of the public and private sectors, a comparison which is of obvious importance for the direction of policy

The art of budgetting is a two-way looking process, the plans for the future must be grounded on the experience of the past This end is provided for by the arrangement of the Budget Speech, which is traditionally divided into three parts, first a presentation of the revenue and expenditure accounts for the year just ended, secondly, a forecast of the extent to which the Estimates for the year just beginning (which will already have been before Parliament for several months) would be covered—or more than covered—at existing rates of tax, and finally, a recommendation of adjustments in taxes, calculated to bring about the desired balance at the end of the year

The method of presentation of the accounts of the central government is most clearly seen in the Budget Estimate which appears at the end of the Financial Statement It will be interesting to look at the plans presented to Parliament in April 1938 and in 1953, the years whose revenue and expenditure we have already examined Since the account is just a summary of the estimates for expenditure and revenue placed against each other, we need not comment in detail on the separate items (See Table IV)

As we have seen, 1938, like 1913, was reckoned as a statistical base year, subsequent movements in economic series being measured from it Unfortunately, on account of the international tension, it was not a very normal year, and this is reflected in the Budget by the provision of £90 mn estimated to be covered by borrowing, and the £10 mn reserved for unforeseen contingencies In a more normal year, such as 1953, there would have been no mention of borrowing in the Budget, and there would even have been no allowance for

TABLE IV BUDGET ESTIMATES FOR THE FINANCIAL YEARS 1938–39 AND 1953–54
(TO NEAREST MILLION £S)

Estimated Revenue				
Inland Revenue	*1938*		*1953*	
Income Tax	341		1 782	
Surtax	62		127	
Death Duties	88		160	
Stamps	24		52	
Profits Tax, etc [1]	1		315	
	—	537	—	2,436
Customs and Excise				
Customs	228		1 044	
Excise	116		680	
	—	344	—	1,725
Motor Vehicles		62		69
Total Taxes	—	917	—	4,230
Post Office		11		2
Crown Lands		1		—
Sundry Loans [2]		5		25
Miscellaneous [6]		11		111
TOTAL REVENUE		945		4,368

Estimated Expenditure				
	1938		*1953*	
National Debt	230		615	
Payments to N Ireland	9		48	
Miscellaneous Cons Fund	3		10	
	—	242	—	673
Supply Services				
Defence				
Army	86		526	
Navy	94		330	
Air Force	73		498	
Departmental [3]	—		143	
Other	—		139	
	—	253	—	1,636
Civil Votes				
Administration	53		282	
Social Services	332		1,462	
Economic [4]	41		172	
Cost of Tax Collection	14		44	
Margin for Supplementaries	10		—	
Total Supply	—	450	—	1 960
Total Expenditure	945		—	4,269
Estimated Surplus [5]				99
		945		4 368

NOTE The account has been slightly rearranged from the presentation in the Financial Statement in order to make it more functional

[1] N D C Profits Tax" special contribution of 1948 Excess Profits Levy of 1952 and the defunct Excess Profits Tax
[2] Interest and Capital Repayments
[3] Ministry of Supply (Defence) and Ministry of Defence
[4] Including central share of roads
[5] Actually £ 35 mn in 1938, exclusive of defence loans outside the Budget
[6] Including Broadcasting Receiving Licences

contingencies, because Chancellors are expected to provide exactly for all possibilities at the beginning of the year,[1] in order to make Treasury control over the accounts as complete as possible.

It so turned out that in 1938 tax collections were £16 mn. below the Estimate, but as defence expenditure did not mature so rapidly as had been anticipated, total outlay was £123 mn. below the Estimate, so that a surplus was realized. This was not an unsatisfactory piece of budgeting in view of the many unpredictable factors in that uneasy year. In 1953 revenue was returned exactly as estimated, but tax receipts were £53 mn. below the Estimate, the total being made up by an increase in "Miscellaneous". On the other hand, the outlay total was £15 mn. above the Estimate, so that the surplus was rather less than had been planned. The divergence from the estimates was, however, relatively small in relation to the magnitude of the figures involved. At the same time it must be realized that this arrangement of the accounts bears little relation to economic realities, being in fact a historical survival. The true surplus or deficit can (as we shall see later) by no means be read off from the traditional arrangement of the Budget. In normal times British estimates of revenue and expenditure have been correct to within a few hundred pounds, a result which is a striking tribute to the efficiency of the financial administration. It is an achievement which can best be appreciated by remembering the many centuries which have gone to the perfecting of the technique,[2] and by observing the difficulties experienced by other countries in attaining even this degree of proficiency.

Budgeting, as it has long been understood in England, is for most countries a comparatively recent innovation. By the time that the smoke of the 1914–18 war had cleared away, the governments of most countries had indeed come to present

[1] In fact in 1953 a substantial surplus was budgetted for in order to counteract inflationary pressure.

[2] It has been claimed that there were "traces of an organized financial system in England at a surprisingly early date"—e.g. in the ninth century under King Alfred. Cf. F. M. Stenton, *Anglo-Saxon England*.

some sort of annual statement of taxation and public expenditure, but in many cases it was far from complete In the U S A , in spite of the enormous improvements in financial control which have recently been made, it is as we have seen[1] still the custom to present no consolidated finance bill Revenue is only available as Congress successively brings itself to the point of agreement on the necessary taxes This practice inevitably weakens the financial administration, it may lead to a considerable amount of at least short-term borrowing, where tax revenue ought to be available

A much more serious weakening—which is still by no means rare—is a failure to collect (because of tax evasion), or perhaps even to plan for (because of the weakness of the government) sufficient tax revenue to cover the current expenditure which had already been agreed upon Governments in such a predicament are accustomed to bundle all the uncovered expenditure—whatever its nature—into an "extraordinary" or "capital" budget, which for the foreseeable future at any rate had to be covered by borrowing, probably from the central bank If "double budgetting" of this nature becomes chronic, there is a risk of undermining confidence both in the financial institutions whose stability is threatened by the government's importunity and even in a political system where governments cannot keep their affairs in order

In the inter-war period, however, another kind of double (or rather divided) budget was adopted in some countries—notably Denmark and Sweden—in which separate account of capital expenditure was taken in an annex to the ordinary budget This kind of budgetting is not merely very different from the chaotic state of affairs where the "capital" budget is little more than a cloak for weakness or incompetence, it is also a considerable improvement on the traditional British system, because it is capable of being used as an instrument of policy, which the British budget in its traditional form is not At a later stage we shall have to discuss the application of this,[2]

[1] Cf p 61
[2] Cf Chapter XX, Section 2

and other, improved budgetary techniques to British conditions The need for budgetary reform arises essentially from the cnanged purpose for which the accounts are now required

The primary purpose of the traditional British Budget is first (in the Estimates) to record the agreement of Parliament to a particular lay-out of public revenue (arranged for in the Finance Act), and later (in the Appropriation Accounts), to certify to Parliament that the revenue has been provided and applied as agreed The necessity for Parliament to assure itself in detail on these matters is a survival from the days when kings were liable to divert to their own uses monies provided by Parliament for the public services In fact, Parliament now relies on the Treasury to see that all is in order, and the detailed form of the Estimates, on which the Budget is based, is really to enable the Treasury to carry out its traditional process of control

As we have seen, however,[1] Parliament has become accustomed to make use of this form of presentation of the accounts for quite another purpose, the Votes and Heads into which the Estimates are divided provide a convenient classification of expenditure from the point of view of choosing suitable subjects foi debate in Committee of Supply This second purpose of the Estimates increases the difficulty of reforming the accounting system, but it could be served just as well by a more summary list of subjects, which would allow of more flexibility in accounting methods

It is not merely the method of presentation of the public accounts which is a suivival from conditions which have passed away, the trouble goes considerably deeper The actual method of accounting used reflects a stage of economic and political development when accounting technique was dominated by practices appropriate to personal or family expenditure In order to facilitate the traditional method of Treasury control, the accounts of government departments are kept on a strictly cash basis, only those payments which have actually been made during the relevant period figure in the

[1] Cf p 52

accounts Other transactions which may have been concluded in the accounting period, and which properly belong to it, are unrecorded so long as cash has not been paid over The public accounts are thus merely a cash record, not a true expenditure account, thus they do not provide an accurate record of government activity during the year, and are hardly superior in technique to that of a penny cash book

Moreover, in the Estimates, expenditure is grouped by subject not by service To take an example at random, in 1935, Class VI, Vote 1, Head A (General Administration of the Board of Trade), was divided as follows A1, Salaries, etc , A2, Travelling and Incidental Expenses, A3, Special Services, A4, Telegrams and Telephones, A5, Expenses under the Dyestuffs (Import Regulations Acts, 1920–24) (The last item looks suspiciously as if it had been put there for want of a better pigeon hole) On this method of accounting it is next to impossible to compute the total cost of any particular service For instance, if we want to find out the cost of the services provided by the local Employment Exchanges, we can start by finding the cost of the salaries of the local staff—separately accounted for under Class VI—but we are at a loss for the cost of the time of the central staff taken up by connection with this service, which can be by no means negligible The cost of the buildings and furniture, and purchases of stationery and other stores, are merged with the cost of similar materials used by other departments—mainly under "Common Services" in Class VII—so that we cannot isolate them properly

The result of this method of accounting is that it is impossible for any revising body, whether the Treasury, the Public Accounts Committee, or an *ad hoc* Committee on National Expenditure, to say whether a department is being run well or badly It is usually impossible for the head of a department to tell what his department is costing at any particular moment, much less to compare it with the results of previous years or other departments In short the method of public accounting is adapted to reveal dishonesty, but not incompetence, in the public services

This obstacle to an intelligent control of expenditure was acutely realized by the Committee on National Expenditure which sat during the 1914–18 war As a result of their repeated expostulations some improvement was made in the accounting methods of the trading services The Post Office, including the telephone and telegraph services, brought its accounts more into line with those of a business firm A reconciliation account was then drawn up to square these with the Estimates An interesting experiment was also made on the advice of this Committee in the arrangement of the Army accounts Instead of the traditional "subjective classification (e g petrol for the forces wherever consumed), an objective" or modified unit cost system (e g, the cost of man bed hours in military hospitals) was tried for a few years Unfortunately this eminently intelligent experiment proved too ambitious for the time We must not, however, linger over these questions here, since we shall have to pay considerable attention to them in Part III

One of the continuing shortcomings of the traditional Budget is that it fails to distinguish the different types of expenditure according to their economic significance Expenditure on current account may consist of the purchase by public authorities of goods and services, the services of civil servants and other employees, the goods used in collective consumption (e g, in schools) or in the trading services Alternatively, it may take the form of a transfer from the incomes of one group of citizens to supplement the incomes of another Such transfers are of two kinds, payment of National Debt interest to the owners of war loan and other government stocks, and social transfers, e g, pensions and other payments made as part of general social and economic policy

It is highly desirable to be able easily to distinguish these two forms of public outlay in the accounts, because the first—expenditure on goods and services—generates new incomes directly, whereas transfers do not, although, of course, additional incomes may later be generated if the recipients spend the additional income while the transferers would have saved it

The failure of the Budget adequately to segregate current and capital items should also be stressed The Chancellor's Budget as traditionally arranged may well include capital items on both sides of the account On the expenditure side a considerable proportion of the cost of roads and buildings is really new investment financed out of revenue, on the revenue side, there is included both interest and repayment of capital, while the Miscellaneous item was notoriously used in the past to bring out the desired answer irrespective of the character of the payments included Even in more recent situations it has tended to include a number of capital items In the past the failure to distinguish capital from current items was of secondary consequence, but immediately an active economic policy is adopted it becomes of first rate importance These again are matters with which we shall be concerned in Part III

In view of these deficiencies of the traditional Budget it is not surprising that the necessities of war finance called forth a source (the White Paper on National Income and Expenditure) of additional information on both these heads, as well as giving much further information on the whole state of the economy British national income accounts, however, are not capable of integration with the Budget because they refer to a different accounting period the calendar year and not the financial year In spite of the great progress that has been made since 1941 in adapting the public accounts as an instrument of policy much still remains to be done

§ 2 **The Consolidated Account of the Public Sector** The National Income and Expenditure accounts set out a "balance" of each component of the Public Sector the Central Government, the National Insurance Fund and the Local Authorities, but so far they have not presented a consolidated account for all public authorities taken together, although of recent years the national insurance fund revenue and expenditure has been consolidated with the central government accounts Yet it is clearly of interest to ascertain what contribution public

authorities as a whole made to the national income and its redistribution, and what the final result of their activities was, in terms of contribution to or subtraction from the aggregate supply of savings in the economy Let us try, therefore, to fill this gap in respect of the two years which we have been discussing, 1938 and 1953 In respect of 1953 almost every step can be estimated directly by re-sorting the figures in the Blue Book, but for 1938, for which fewer figures are available, we must rely on the number of sources, drawn up on bases and for periods which are not strictly comparable There seems no reason to suppose, however, that the result which we can obtain is seriously wide of the mark

In order to consolidate the separate accounts it is necessary to eliminate all payments between one authority and another, in order to avoid double counting Thus from the account of the central government on the revenue side we must subtract the taxes paid by local authorities, from the revenue account of the insurance fund we should deduct the contributions of the central government in respect of the armed forces From the account of local authority revenue we must similarly deduct payments from the central government, grants on current account and payments in lieu of rates on Crown lands, housing subsidies from the central government and interest received from other local authorities On the expenditure side of the respective accounts we must make consequential deductions Most of these adjustments can be made quite simply, the main exception is the outlay taxes paid by local authorities to the central government, in respect of petrol, vehicle licences and other taxed commodities which they consume Since there are no figures for these we must just remember that the revenue side of the consolidated account will be somewhat inflated on account of incomplete consolidation

One further point arises The revenue account of a public authority is not quite the same thing as a current account in an economic sense, because it contains items which are in fact transferred to capital account or reckoned in the capital account of some other sector The chief items involved are, on

the revenue side death duties, and on the expenditure side payments in respect of war damage and refunds of excess profits tax to firms, and capital grants to local authorities Since the figures (at least for 1953) are taken from the estimates of the Central Statistical Office and not from the traditional form of government accounts, they do take into account the transactions which properly belong to the year, irrespective of whether payment has actually been made or not Thus the balancing item in the account, the net figure of saving by public authorities is economically correct so far as the data will allow

The result of the estimate is shown in Table V Perhaps the most notable phenomenon in the account is the relative stability (or rigidity) of the position of the local authorities, when compared with either the central government or the national insurance fund, both on the revenue and on the expenditure sides In the case of the insurance fund the expansion[1] is, of course, due to the extension of social security to the whole nation The central government has expanded all along the line, although in a number of items transfers from some other sector, rather than new services, are reflected Thus the increase in income from property is largely on account of interest payments from local authorities who formerly borrowed from the private sector Of central expenditure on goods and services the major item (£1,545 mn) is accounted for by defence, in one way or another, the other large item is the £441 mn which the national health service cost Among the transfers the largest item is the £625 mn for the service of the national debt, other substantial items are £524 mn of national insurance benefits and £427 mn of other pensions, assistance and grants to persons Grants abroad represent mainly outlay under the Colonial Development and Welfare Acts, before the war outlay of this nature was negligible

It will be seen that in 1938, on this reckoning, a substantial deficit was realized, in spite of the fact that the budget showed

[1] In terms of constant prices the 1953 figures should be deflated about $2\frac{1}{4}$ times

TABLE V CONSOLIDATED CURRENT ACCOUNT OF BRITISH PUBLIC AUTHORITIES IN 1938 AND 1953 (£mns)

Incomings	*1938*		*1953*		*Outgoings*	*1938*		*1953*	
1 *Tax Receipts*					1 *On Current Goods and Services*				
Central Government	773		4,030		Central Government	455		2,352	
Social Insurance	109		526		Social Insurance	14		32	
Local Authorities	211		436		Local Authorities	355		737	
		1,093		4,992			824		3,121
2 *Income from Property*					2 *Transfer Expenditure*				
Central Government	22		177		Central Government	312		1,385	
Social Insurance	neg		48		Social Insurance	136		524	
Local Authorities	49		102		Local Authorities	23		47	
		71		327			471		1,956
3 *Current Grants from Abroad*	—			105	3 *Current Grants Abroad*	—			56
					Net Expenditure of Public Authorities	1,295			5,133
Total Revenue	1,164			5,424	Net Saving by Public Authorities	−131			291

an apparent surplus This result was due to preparations for defence rather than to economic policy, although the level of unemployment would have merited a sizeable deficit if an overt policy of compensatory finance had been followed In 1953 on the contrary a substantial surplus was realized, and this was intentional, as a contribution towards the control of a potentially inflationary situation The surplus would have been considerably smaller, however, had it not been for the grants of the American government under Mutual Aid

One final word of explanation the saving thus shown is *net* in the sense that it is a consolidated figure, it is, however, gross in the sense that depreciation has not been deducted In fact public authorities do not charge depreciation except on their trading services (in respect of the central share of these the "Blue Book" gives a nominal depreciation figure of £37 mn in 1953) Both central departments and local authorities possess a number of fixed assets which have to be maintained, and it is arguable that this would be better carried out if in fact depreciation was budgetted for upon them This is a question which we shall have to discuss along with other problems of budgetary technique, in Part III (Chapter XX)

§ 3 The Public Sector in the National Economy To get a rounded picture of the relative importance of the public sector in the national economy it is necessary to take into consideration the capital account also This is illustrated in Table VI for 1938, 1944 and 1953 Capital formation is shown *gross*, that is to say both the maintenance of existing assets and the formation of new fixed assets are included To get the complete capital position it would be necessary to take into account also changes in stocks of raw materials and semi-finished products This is not possible for the earlier years and even for 1953 the figures are less reliable than those relating to fixed assets Fortunately, from the investment point of view, stock changes are normally considerably less important than changes in fixed capital formation

TABLE VI The Private and Public Sectors of the British Economy

	1938	1944	1953
Private Sector			
Personal Expenditure on Consumption	4,153	5,216	11,076
Private Gross Capital Formation[1]	550	224	1,016
Public Sector			
Public Expenditure on Current Goods and Services (Public Consumption)	814	5,221[2]	3,074
Public Gross Capital Formation at Home	235	63	1,317[3]

[1] Including the cost of acquisition and transfer of property

[2] Excluding outlay financed through lend-lease and similar arrangements

[3] Including the public corporations

The effect of the war is very evident in both accounts At the height of the war *net* investment was negative in both sectors, it has been estimated that *net home* investment was negative to the extent of £202 mn in the private sector and of £42 mn in the public sector in 1944 In the private sector the disinvestment of 1944 followed a previous disinvestment of £730 mn spread over the previous four years Even this does not give a complete picture of the internal capital position because it makes no allowance for the deterioration of household goods and domestic capital of all sorts It is necessary also to take into account the sacrifice of foreign assets due to the war In 1938 this already amounted to £70 mn (of which, however, £55 mn represented the sale of gold which had been acquired over the preceding few years) By 1944 foreign disinvestment had risen to the large sum of £655 mn, and the process continued steadily year by year until 1947, it was only by 1952 that a steady rate of new overseas investment appears to have been re-established

In the private sector it will be observed that expenditure on consumption in 1953 was broadly similar to that of 1938 measured in stable prices In 1944 it was, of course, sub stantially lower in real terms On the other hand capital formation in real terms was smaller in 1953 than in 1938 This is largely accounted for by the difference in house building,

which was still booming in 1938, but which in 1953 was only beginning to emerge from the fetters placed upon it in the reconstruction period   In the 1930's the low level of industrial development, hampered by poor profit prospects in the depression, was already giving rise to concern   Since then a variety of methods of stimulating investment through tax rebates (which we must examine in Chapter XIX) have been tried, but the position cannot yet be said to be fully satisfactory

Relatively to the private sector, the public sector has, as we know, been rapidly expanding   The increase in public gross capital formation is of even more significance than that in public consumption, because it is more permanent in character   In the near future private gross capital formation may be expected to rise with the increase in private enterprise housing, it is to be hoped that industrial investment will also expand   On the other hand public capital formation is unlikely to fall, in view both of the needs of the nationalized industries and of the large programme of slum clearance which is contemplated

PART II

THE THEORY OF TAXATION

CHAPTER VII

THE ART OF PUBLIC FINANCE

§ 1 **Political and Economic Aspects** In Part I we examined the administrative mechanism of the system of public finance The most obvious enquiry to make concerning a piece of machinery is what it is supposed to do or produce At the outset of our examination of the effects of public finance it will amply repay us to pause for a moment in order to consider the nature of public finance and the role which it should play in the community

Our investigations in Part I have shown that public finance is closely related to politics, the art of governing This must necessarily be so since public finance is concerned directly or indirectly with the actions of governing bodies The proper conduct of a country's finances is one aspect of government, and clearly one aspect cannot be studied successfully in isolation Indeed the entire political organization is relevant to the understanding of public finance For instance, the significance of a departmental estimate depends upon the political system in operation (contrast the practice even in two such similar democracies as Britain and the United States) Again the annual routine of financial planning which we have studied in detail is conditioned by the British Parliamentary system Nevertheless, public finance is not a department of politics, it is concerned with the satisfaction of wants, not with the art of governing

The fact that public authorities exist for the satisfaction of the wants of the citizens puts public finance firmly into the

field of economics This implies that its study (and *a fortiori* its successful conduct) presupposes a knowledge of the working of the economic system It is further clear that it must belong to the field of *applied* and not to that of *pure* economics Public finance is an art, it is concerned with actual problems If its analysis is to have any practical application, at a very early stage, a particular economic set-up must be postulated, since both the means to be used, their effects, and in some sense even the ends to be pursued, depend on the type of the economy

Thus, as we have seen, in a predominantly agricultural community little use can be made of the income tax Again an apparently identical income tax may have very different effects in a community where the typical business unit is the small family firm, and where consequently investment is mainly derived from private savings, and in a community where the typical business unit is large, and markets more or less monopolistic Most important of all such differences are those concerned with the optimum size of the public sector in relation to the rest of the economy In one situation the interests of a nation may be best served by a small public sector, leaving private enterprise to invest freely on expanding markets At another stage of its development the same nation may require to enlarge its public sector enormously if it is to take advantage of the less obviously profitable methods of improving the standard of living, which may constitute its best path to progress This is a question to which we shall have to return in Part III

From these few examples it is clear that the relation of public finance to the other subjects usually included in economics calls for very careful consideration The duties of the economist to the community cover two quite different services In the first place he must be able to analyse the working of the system, in the second place, on the basis of his analysis, he should be able to offer advice for its improvement Thus the discipline of economics can be divided into two distinct processes In the first place there exists what we may call the positive sector, the business of which is to describe the

economic institutions of the society (for instance, the organization of industry) and to analyse the causal sequence of the reactions of these institutions to economic and other stimuli This part of the discipline may be described as the anatomy and physiology of economics

In the second place, and no less important, comes the normative sector, the business of which is not merely to determine the correct criteria for policy, but also, on the basis of those criteria, to provide a method of selecting the best among a number of possible economic ends, or alternatively, the economically best route for attaining a given non-economic end Continuing our medical metaphor this section may be said to deal with the preventive and therapeutic sides of economics

Public finance, being a part of the general study of economics, also possesses a positive and a normative side, but they have their special characteristics due to the field of operations of the art

One part of positive public finance is concerned with the description and analysis of the machinery of public expenditure and of the assessment and collection of revenue A knowledge of the parts of this machinery is necessary to understand its working, e g , the way in which a particular piece of fiscal policy—a new type of expenditure or a tax change—will affect the economy Differences in national constitutions and conventions may, as we have seen, make considerable differences to the significance of taxes, or to the means which are practicable for the general direction of fiscal policy To study this machinery in respect of the British economy has been our task in Part I

A second and more fundamental part of positive public finance consists in the analysis of the actual process by which taxes (or subsidies and transfers, which are merely negative taxes) of particular types work through an economic system This analysis is necessary to discover the economic consequences of fiscal changes, and only if the process is carefully traced is it possible to judge the relative merits of alternative

means of reaching a given end, and so to choose the best method It is convenient to refer to this analysis as the theory of Taxation, or Tax Incidence, although it is also concerned with certain types of expenditures We shall be occupied with this type of analysis in Part II It should be noted that it is essentially a "one thing at a time" process made familiar by general economic analysis, in the sense that when we are studying the effects of a particular fiscal change we neglect changes in the economic set-up which are not, directly or indirectly, due to it The entire new set-up caused by the change must, however, be examined [1]

The third and final part of positive public finance (with which we shall be concerned in Part III) consists in an analysis of the combined effects of the entire system of public finance on the national income, it embraces the fiscal policy of public authorities in the fields of current expenditure, investment, taxation and borrowing This analysis is clearly an essential foundation for a systematic policy of high economic activity and for the direction of social policy, but a knowledge of the theory of tax incidence is an equally necessary requisite, in order that the means selected for bringing about the high level of activity shall be satisfactory from other points of view as well It will be seen that the theory of tax incidence corresponds in the field of public finance to the theory of the firm or industry in general economic analysis, while the theory of public finance in the national economy is related to the general economic theory of business activity

§ 2 **The Choice of Policy** The positive side of public finance, however, cannot long be kept apart from the normative side The analysis of the working of taxes or expenditures is not an end in itself, but merely a step in the process of selecting the best policy On the normative side public finance again shows itself to be merely a department of economics

Just as positive finance is concerned with a particular department of economic analysis—the effects of the financial activities

[1] For further discussion of this point, see pp 104ff

of public authorities—so normative public finance is concerned with judgments on particular types of economic policy, those which are, or may be implemented by, programmes of expenditure or of revenue collection, the ends which are sought in this manner cannot, however, differ in any way from those sought by other types of economic policy, and may more conveniently be implemented by different means than by public finance

The policy which is adopted by a nation—such a policy, for instance, as is reflected in the annual financial programme which we have been examining—is composed of a number of strands, some of these have a non-economic, legal or psychological basis—for instance, the desire for legal equality, satisfied by Adam Smith's second duty, or arrangements to secure religious freedom The greater part of policy, however, is concerned with the satisfaction of wants which are similar in kind to those satisfied (or which could be satisfied) through the market mechanism, in this sense they are individual economic wants, although they may more conveniently be provided on a collective basis

As the field covered by public sectors expands, the proportion of public expenditure and revenue, and hence of fiscal policy, which is devoted to these economic ends also expands, because the non-economic wants which can be satisfied by government action are necessarily more limited than the economic wants Hence as public sectors expand it becomes increasingly necessary for policy to be based on firm and objective criteria to which all schemes can be referred, without a definite goal the ship of policy is rudderless, at the mercy of the drifting tides of particular interests In such a condition it is not merely impossible to draw up a satisfactory progamme of the things which should and which should not be undertaken by public authorities, it is also impossible to allot priorities on any rational system between alternative policies, all of which may be accepted as desirable, but which the resources of the economy are not sufficient to implement simultaneously

It must be logically possible to find and to state such

objective criteria for all that part of policy which is concerned with the satisfaction of economic wants by public action With the current expansion of public sectors this problem is of urgent topical importance, but unfortunately it has received far too little attention In order that our analysis may not be left floating in the air, but be made to yield definite conclusions, we cannot avoid attempting to state the criteria of policy, however briefly and inadequately

Remembering that the final end of policy is the satisfaction of wants, an obvious first stage in our quest is to state that the means of satisfying wants—production, output—must be maximized Clearly if production, with a given volume of resources, is not maximized, however the product is distributed, satisfaction is less than it should or might be The maximization of output, the "production optimum", is thus concerned with the allocation of resources, the condition for maximization of output is that with any given system of products it *should be impossible, by reallocating factors, to increase the output of one product without diminishing that of another* [1] This criterion is perhaps not much more than a precise way of stating the oft-quoted maximum condition of equi-marginal returns to factors, but it has the decided advantage that it is independent of any particular system of price weights which may be given to the products, so that it is of general application

So far there is no logical difficulty, although when we consider the problems set by such complications as indivisibilities, external economies, and complementarity of factors, the implementation of a policy of reaching the productive optimum clearly sets many problems of a technical nature The second stage in the pursuit of the economic absolute is a little more complicated Among production optima we have to choose the set-up which will maximize *satisfactions* And here we are up against the difficulty of comparing one person's satisfactions with those of another The most plausible way out of the tangle of incomparability of utilities is by the route of compen-

[1] For a more precise, but essentially similar definition cf P A Samuelson, *Foundations of Economics*, Chapter VIII, especially p 230

sation If a particular redistribution of products will make the first individual so much better off than he was that he can compensate the second man and still remain better off[1] than he was initially, then both must agree that the change would be an improvement The maximization of satisfactions, the "utility optimum", may hence be formulated precisely, in a manner parallel to the production optimum *Utility is maximized when it is impossible to increase the satisfaction* (improve the position) *of one individual without diminishing the satisfaction of another*, after full allowance has been made for compensation

The utility optimum clearly takes us up to a higher stage in defining the course of policy, because it brings us into view of the final goal, which is real income and not real output It does so by eliminating the degrees of freedom which would otherwise exist in the organization of production Something akin to the utility criterion has been sought in the form of equi-marginal social net products, the concept of social net product, however, contains too many unmeasurable quantities for the basis of actual policy Both the production and utility optima in the form just stated are capable of being brought into relation with statistical and econometric enquiries, and so are capable of becoming practical directives of policy

It is obvious, but should perhaps be emphasized, that both criteria need to be interpreted in a dynamic sense, the production that is to be maximized is not this year's or next year's, but is the present value of a future output stream, discounted at whatever rate defines an acceptable compromise between the mortal nature of the individual and the immortality of the community The utility optimum must similarly be conceived as realized by a stream of satisfactions through time Some of the increase in satisfaction which will signalize progress towards the optima will take the form of a better provision for wants already conscious, and probably already partly satisfied, there is also, however, a large field for the development of want-consciousness, which will lead eventually to higher levels

[1] In economic terms, on a higher point on his indifference map

of satisfaction In this field public authorities can play an important role

§ 3 **The Implementation of Policy** Having defined our criteria of policy, we must now attempt to see how they can be applied to the actual direction of policy Starting with an economy as a going concern (as we must do) we have a given short period potential supply of factors, i e, the labour and capital existing or shortly obtainable through production with existing equipment, or by exchange The first condition, required for the production optimum, is that these factors should be fully and continuously employed We must then use the utility optimum to discover just in what way they should severally be used

In any economy there are always likely to be an indefinite number of schemes which are potentially eligible for inclusion within the scope of the utility optimum, in the sense that they would severally increase satisfactions and still leave a surplus over cost, after compensation had been paid for lost satisfactions By estimating for different schemes the relative magnitude of these surpluses, a definite and objective system of priorities can in principle be established Given adequate statistical data of costs, it should be possible to do this with a reasonable degree of accuracy In practice difficulties may arise—for instance, owing to discontinuities where the minimum outlay is large—but for the most part it should be possible to make marginal adjustments which are small from the point of view of the whole economy, although they may be large from the point of view of a single unit of control [1]

When the matter is put in this way the important role which public finance must play in the attainment of the optima is at once apparent The production optimum can only be reached with a technically correct allocation of factors, in practice there are many reasons why it is often difficult to realize this allocation For instance, monopolistic control of markets may impose an obstacle, again an inadequate educational system

[1] For further discussion of planning difficulties cf Chapter XVIII

may prevent the best use of the nation's talent Technical obstacles of this nature are very amenable to treatment by fiscal means, through the use of particular taxes, or the development of particular types of expenditure Again, on the plane of the relation of public finance as a whole to the economy as a whole, fiscal policy can be directed both to making the public sector the supporting and balancing factor in the economy, and to influencing the activities of the private sector in a direction appropriate to the criteria of policy

The production and the utility optima are, it will be observed, independent of the type of political organization, in principle they can be pursued successfully by governments of very different political flavour, although the working out of the utility optimum principle will no doubt differ according to the type of government

Thus some revising agency (for which the government must be ultimately responsible) is required to take into account when determining policy programmes those "community effects" of individual actions which are not apparent to the individual (For instance, the backwash of A's actions on B will not be taken account of by A because they lie outside his private accounting system, either considered as the utility accounts of the consumer, or the production accounts of the firm) In the productive field effects of this nature have long been recognized as a type of "external economy" (or *mutatis mutandis* dis-economy), but so far policy has almost entirely failed to take them into consideration In the field of consumption "community" or "neighbourhood" effects of this nature are less important, and up to the present much less attention has been paid to them [1]

Many of the functions of the State in thus revising and integrating policy, whether they are actually performed by the legislature directly or by an agency (e g , the judiciary acting under legislative direction), are closely related to fiscal policy In order for them to be carried out to the best satisfaction of

[1] Cf Meade, "Mr Lerner on the Economics of Control," *E J*, April 1945

the community it is clear that the government must reflect the real wishes of the people as faithfully as possible It does not lie within the field of economics to discuss the precise form of political organization which will satisfy this condition most appropriately, any more than it does to determine the content of the remaining non-economic strands which go to complete the fabric of policy Since the economist has nevertheless a responsibility in the implementation of these other strands of policy it is necessary for him to be conscious of their nature

Some of the non-economic strands of policy are of supreme importance for the life both of the individual and of the society, indeed they take us beyond the utility optimum in the sense in which we have defined the maximization of satisfactions That this is so is shown by the willingness of members of the society to lay down their lives in order to secure for their families and descendants the sort of system of which they approve In policy of this nature must be included the fundamental physical and psychological needs which Adam Smith had in mind as pertaining to the "First and Second Duties of the Sovereign" For policy of this nature there can be no question as to whether resources can be spared, since it must take precedence over the realization of the normal optima of policy

Besides these fundamental needs of man in society there are also other psychological and social needs which although less fundamental are deeply engrained in the ideology of particular societies, and of which consequently the economist must be aware when he is advising upon policy implementation, although again he must take as a datum the ideology which is enshrined in the policy An example of such a strand of policy which is peculiarly strong in Britain is the idea of social justice, expressed in the present generation by a demand for the redistribution of income, but traceable in tax ideals stretching far back into history [1] The economist has an important duty to perform in respect of this policy, he is responsible for reporting to the community on progress, e g, on the effects

[1] Cf Chapter VIII

of any particular measures of redistribution (or the general pace of redistribution) on the production and utility optima respectively Policy of this type if carried to extremes may conceivably conflict with the pursuit of the optima, armed with the economist's report it is for the government to take the responsibility for deciding between conflicting ends Still other types of policy, even those desired by majorities, may conflict more seriously with the pursuit of the optima (we might take as an example the determination to establish an industry for which conditions are unsuitable) Policy of this nature needs to be measured very carefully against our criteria It is unfortunately within the power of majorities to inflict lasting damage on an economy by the pursuit of ends for which the means are not available

It will be clear from our discussion that in a developed community economic aspects claim a large part of the field of policy The art of public finance thus takes its place alongside the other means of implementing policy—direct control (by rationing, direction and conscription) on the one side and on the other, indirect control of private production and consumption by monetary policy

These three methods of implementing policy, public finance, direct control and monetary management, are very closely related to each other In practice they can often be made to supplement and support each other, as when in war-time subsidies on essential foods are backed up by rationing The connection between public finance and monetary policy is particularly close because they both impinge on monetary institutions, especially on the capital market (Hence it is especially necessary that monetary and fiscal measures should be complementary and not conflicting) In spite of this close relation, the scope of the two methods of implementing policy is quite distinct, for monetary policy influence on the capital market and on monetary institutions is the *purpose* of policy, while it is the *result* of public finance

Of these three methods of implementing policy, public finance appears to be the most powerful and generally useful where it

can be properly applied On the one hand, in normal times the scope for direct controls cannot be large without a danger of infringing essential liberties, on the other, fiscal policy has the advantage over monetary policy that it can be applied just at the point where stimulus or pressure is required, whereas monetary policy inevitably goes bludgeoning all round the economy

Further, whereas monetary policy can only operate with indirect effects, fiscal policy can be turned at will either to the direct production of satisfactions, or to their indirect production through the stimulus or control of the output of the private sector Thus the adoption of particular ways of raising revenue may in itself lead to an expansion of income per head (for instance, by promoting industrial efficiency) or to a better reflexion of preferences on the market (for instance, by bringing prices nearer to marginal costs), while at the same time the expenditure of revenue promotes progress towards the optima (for instance, by the dynamic development of the utility optimum, through better housing or education)

Although it is only the modern development of economic analysis which now enables us to formulate the criteria of policy precisely, in a crude form they can be shown to have been present in the minds of the framers of British fiscal policy from the seventeenth century, from the moment when Parliament finally got full control of the revenue Until well on in the nineteenth century, however, pursuit of the optima was almost wholly conducted on the tax side This was inevitable because the greater part of the revenue was required for the satisfaction of the fundamental (non-economic) needs of the community, which as we saw must take precedence over other wants Thus until quite recently the ideals of public finance were comprised in the theory of tax incidence, before the Gladstone era it was not even realized that the tax structure could, and should, be treated as a unity from the point of view of policy [1]

Once it became possible to think in terms of a complete tax

[1] Cf p 131

structure, instead of in terms only of its components taken separately, a broader outlook was conferred on policy. It began to be perceived that the tax structure might itself be used as an instrument of policy. Since, however, the main emphasis continued to be on the theory of tax incidence, the principal advice that the nineteenth century had to offer on the policy of public finance was that the public sector should be kept as small as possible. In the mid-nineteenth century, the age of rapidly expanding population and markets, this was sound economic sense. The opportunities for pioneering by private enterprise were enormous, and no assistance from public sector was required to secure a high level of activity. Nor would it have been possible for the public sector, with inadequate transport and an undeveloped civil service, to take an active part in policy.

As so often happens, however, the policy of slimming the public sector outlived the situation in which it could plausibly be regarded as economically appropriate, but so long as ideas of social and economic expenditure were relatively undeveloped, the scope for expanding the public sector remained limited.

The modern analysis of the effects of public finance as a whole, and hence of the place which fiscal policy might play in the economy, followed quickly on the development of the theory of business activity, associated especially with the names of Wicksell and his pupils in Sweden, and slightly later of Lord Keynes and others in Britain; the new theories were first applied in detail to public finance in Sweden in 1934.[1]

The practical application of the new analysis depended, however, on the emergence of two new factors in the situation, first the expansion of the public sector in national economies (due both to the growth of trading services and other forms of

[1] By Gunnar Myrdal, *Finanspolitikens Ekonomiska Verkningar* (The Economic Effects of Public Finance), following Erik Lindahl's pioneer work on the control of the economy through monetary policy, dating from 1928. For further discussion of the revolution in thought which resulted from these analytical developments, cf. Chapter XVII.

public investment and to the development of the social services), secondly, the availability of a better technique for monetary control, once the rigid gold standard of the nineteenth century had been abandoned Without this latter change the new orientation of policy would have been in danger of frustration on the monetary side

CHAPTER VIII

TAX IDEALS

§ 1. **The Principles of British Taxation.** When the finance minister of a country is choosing the taxes to go into his budget, what considerations ought he to have in mind? This is usually the first aspect of public finance to attract attention, because it is a matter that affects every citizen. In England we can trace a long tradition of opinion on tax ideals. Before we pass to the economic analysis of the operation of particular taxes it will be useful to see what general principles have lain behind the levies actually imposed from time to time.

There are, broadly speaking, three different types of question which a finance minister might be supposed to put to candidates for the Budget before admitting them. In the first place he might ask what (if any) other purpose they were capable of serving besides providing revenue for the satisfaction of public wants. Secondly, he might question them about their distributional effect, what classes of the people might be expected to contribute most of the revenue. Thirdly he would have to put them through an efficiency test, to ascertain which were the most economical and effective methods of raising a given revenue, or which taxes were most appropriate for serving other given purposes.

The taxes selected by British Parliaments have usually been required to give fairly specific answers to these questions, at least from the sixteenth century. The answers may be stated in the form of three principles. In the first place the primary purpose of the revenue should be to finance the public services, consequently those taxes should be chosen which would be most efficient for this purpose. Nevertheless, it is permissible in certain circumstances to choose some taxes whose main object is to serve an agreed subsidiary aim, such, for instance,

as improving the balance of payments on international account, or hindering some undesirable form of consumption expenditure. The second principle is that the citizens should be taxed in accordance with their ability to pay, a criterion which should take some account of family circumstances as well as of wealth. Thirdly, taxes should be universal, imposed without distinction of person between citizens similarly placed.

In terms of the policy aims which we were discussing in the last chapter the first of these principles can be related to the productional criterion. The productive optimum in any given circumstances can only be reached if the most efficient taxes are used; a country which tries to make its revenue serve too many subsidiary purposes at once is almost certainly damaging its chance of attaining the optimum. The second principle is concerned with the question of social justice, but it is also related to the utility criterion. The precise interpretation of "ability" inevitably gives rise to differences of opinion. What is really at stake is the relative weighting which should be given to the various factors on which ability may be said to depend. This question cannot be settled objectively, so that the interpretation of the principle must remain a matter of policy, a matter that is for Parliamentary decision. The interpretation put on the second principle has naturally varied with the state of economic and social development.

The third principle is also related to ideas of social justice by way of Adam Smith's Second Duty, since it is concerned with equality before law. It is characteristic of the British outlook that a great deal of attention should have been given to this point, and taxes which were otherwise acceptable were often condemned or even abandoned if they could not be made satisfactory in this respect. The third principle is also concerned, though not very obviously, with the efficiency test, which otherwise does not figure very prominently in traditional discussion. The connection, however, was made clearer in Adam Smith's formulation of the principles of taxation.

In his chapter on the Public Revenue, Adam Smith put forward four canons or maxims of taxation, which have had a

fame which perhaps they hardly deserved, since they appear to have been mainly a reflexion of contemporary opinion The second and third canons (the first is merely a restatement of the distributional principle) lay down respectively that taxes should be certain and not arbitrary, and that the time of collection should be suited to the convenience of the taxpayer—partly a question of equality again but partly also of efficiency. The fourth canon, concerned with economy, is much more interesting and it is worth quoting it in full "Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the State "

Adam Smith probably had in mind here mainly questions relating to the heavy cost of collecting certain taxes in his day (i e , the high customs duties which required an army of revenue officials to prevent smuggling) Later economic analysis has shown that the principle of minimizing the difference between taxpayers' loss and revenue's gain can be used to provide an important criterion of a tax, a criterion which is important not merely from the point of view of the productional optimum but even more so from the point of view of the utility criterion [1]

That Smith was aware of the need for an efficiency test is evident from his canons, that he did not attempt to state it more precisely is hardly to be wondered at when we consider how difficult it was in Smith's day for even a theoretically good tax to be satisfactory in practice, owing to difficulties of assessment and collection Smith was violently opposed to the income tax, which would seem to have been fully in accordance with his canons, it is probable that his opposition was due to his conviction that in practice it would be uncertain and arbitrary

Now, after more than a century of efficient fiscal administration, it may seem that the principles of taxation which we have just listed are so self-evident as hardly to be dignified by the name of ideals They have not always been very well

[1] See Chapter X, Section 3

observed, however, even in this country, and abroad very different principles have often held sway In the history of every country it is easy to find occasions when the revenue has been distorted to serve particular interests, for instance, in the field of foreign or industrial policy The net result of this has been more often than not to damage total output in the interests of particular groups In Adam Smith's day the British tax structure was full of levies and subsidies which had been imposed at different times with the purpose of benefiting particular interests It was largely on this account that it so lamentably failed to provide sufficient revenue to finance the Napoleonic wars [1]

In France at the same date the tax structure sinned to a much greater extent against Adam Smith's canons It is notorious that under the *ancien regime* the taxes were mainly levied on the poor, the rich and aristocratic being very largely exempt A very common way in which the distribution of revenue between different classes of the community has been distorted is by exempting State employees from income taxes, thus constituting them a privileged class Where this occurs it is common to find their privileges backed up by legal exemption from the jurisdiction of the ordinary courts The history of Germany, and even of France, provides many illustrations of the evils to which such privileges may lead

Another common fiscal privilege has been the exemption of interest on the national debt from income tax In the United States this has traditionally been the arrangement Even to-day so much of the debt of the constituent States is tax free that American millionaires can escape no small part of the rigours of surtax by investing in public funds The British tax structure has not always been entirely free from this latter weakness,[2] but on the whole it is true to say that the country has steadily set its face against fiscal privilege, just as it has

[1] Until the introduction of the income tax See p 124

[2] In the war of 1914–18 certain war loans were issued tax free, cf U K Hicks, *The Finance of British Government*, *cit*, Chapter XX

against legal privilege The fact that national debt interest and the salaries of public servants were made subject to income tax by Pitt, on exactly the same basis as other sorts of income, ensured that when the income tax became a permanent feature of tax structure it would contain no privileges of this nature

§ 2 **The Development of Tax Ideals** It is one thing, however, to lay down principles, it is quite another to carry them into practice To what extent can the taxes imposed from time to time in Britain be said to have conformed to the ideals? It would take us too far afield to attempt more than the briefest survey,[1] but even this will serve to illustrate the considerable amount of attention devoted to the tax principles, more particularly to the principles of equitable distribution

We need not start before the time of Elizabeth I, although it is probable that the roots of the tradition could be traced considerably further back [2]

In the sixteenth and seventeenth centuries tax revenue was derived from two sources, a variety of partial taxes on expenditure, and a general tax on wealth At the beginning of the period most of these partial taxes were on imported goods, and according to current theory, lay outside general distributional considerations, because they were regarded as paid by importers, and earmarked for naval expenditure As the needs of the revenue increased and the customs duties were multiplied, their theory could no longer be plausibly maintained, and the distributional aspect of taxes on imports had to be considered For the most part it was aimed to concentrate them on "nice and delicate things", such as silk, wines

[1] In this field much research still remains to be done For the earlier period W Kennedy, *English Taxation, 1640 to 1799*, is invaluable New light on the first income tax was thrown by A Hope Jones, *The Income Tax in the Napoleonic Wars*, and on its further development by F A Shehab, *Progressive Taxation*

[2] The medieval Xth and XVth were in intention proportional to wealth That taxation of the poor could raise a storm at an early date is apparent from the poll tax episode of 1381 Cf also the unbroken development of the basis of the local rate (Cannan, *History of Local Rates*)

and tobacco, from the taxation of which the poor [1] could not be expected to derive much hurt

The chief interest of distributional theory was with the general tax on wealth This had been reformed by Henry VIII under name of "The Subsidy" Liability was fixed at 4*s* in the £ on income, or alternatively at 2*s* 8*d* on the capital value of the source of income The tax was considered to fall mainly on the rich or "the middle sort" A gradual process of totally exempting the poor is discernible and appears to have been complete by the accession of Elizabeth Unfortunately, the public service was incapable of maintaining the intention of the Subsidy, and before the end of the century contributions had become "stereotyped" (tied to conventional assessments) The result of this was a progressive fall in the amount of revenue collected

The revenue needs of the Civil War gave rise to a series of attempts to rejuvenate the Subsidy, the most important of these was the Parliamentary "Monthly Assessment" of 1645 This time the income basis was adopted for all assessments, but in order to simplify the administration, as many taxpayers as possible were assessed by rank or station, only the remainder being directly assessed on salary or other income In order to secure prompt collection it was thought necessary to allow the local assessors to use their judgment as to the most appropriate method of assessment, and presently it was found necessary to allocate a fixed minimum revenue to each district This soon led to a hopeless degeneration in the tax, and gave rise to great unevenness of burden between different parts of the country

This second deterioration of the general tax on wealth made it necessary for further reform to be attempted in the reign of William III when the needs of the revenue once again became pressing The new "General Aid" was again in intention a proportional tax "according to yearly profits" In practice it was assessed in three ways, directly on salaries, indirectly in respect of income from moveable property by imposing a

[1] It should be noted that throughout English tax theory "the poor" connotes the manual working class, and not the recipients of poor relief

percentage on the capital value, and finally, in respect of income from real estate by collecting tax from the tenants, who stopped it out of the rent [1] It soon became apparent that it was still beyond the powers of the authorities to collect tax on income from personal property, so that in fact the Aid became a Land Tax Throughout the eighteenth century it remained an important source of revenue, and it is still paid (but has no longer any fiscal importance) on certain old houses in respect of which it has never been redeemed by a capital payment

It seems clear from these efforts that in the sixteenth and seventeenth centuries it was the intention of the legislature to raise an important part of the revenue by a general tax proportional to ability to pay, from contemporary writings it would seem that it was customary to pay some attention to family circumstances as well as to wealth [2] The fact that what emerged was a partial tax on income from real property was due partly to the relative ease with which income from this source could be assessed and the tax collected At the same time land remained by far the greatest source of income until some way through the nineteenth century, so that the greater part of the receipts of an effectively general tax would also have come from land The partiality of the tax does not seem to have been a source of serious complaint until well on in the eighteenth century

There is no doubt that these "general" taxes were mainly paid by the wealthy, and the poor were virtually exempt The result of sixteenth- and seventeenth-century policy was to fix the doctrine that income was the proper standard of equitable tax distribution

In the later seventeenth and early eighteenth centuries the strain on the exchequer of long periods of war required the discovery of another source of revenue This was found in the imposition of taxes on home-produced goods known as

[1] In exactly the same way as much of Schedule A income tax is collected to-day

[2] Cf , for instance, Gibbons, *Discourse on the Diminution of the Subsidy* (quoted in Kennedy, *op cit*), "Sessors ought to look into the charge of a man's family before they can well tell how to charge him by his ability "

excises [1] During periods of exceptional strain (such as under the Commonwealth and again in the Marlborough wars), excises were freely imposed on commodities which were largely bought by the poor (especially beer, leather and salt) At first accepted because of the dire needs of the exchequer, and then condoned because of their impartiality, it was later argued that after all the excises were not distributionally unsatisfactory, because rich households made larger per head purchases of taxed commodities than poor families Only a few of the clearest brains perceived that the excises were still unsatisfactory unless the rich bought *proportionately* more than the poor, which was not very likely

A more serious argument in favour of taxes on general consumption was derived from Locke's political philosophy [2] which became fashionable in the eighteenth century This put forward the concept of the State as a voluntary association for the sole purpose of providing for the primary collective wants Since all must share these wants it was just that each should contribute to their satisfaction, no matter how humble his station This view was never universally accepted [3], in Parliament (which consisted mainly of landowners) there was always lively interest in the welfare of the poor, the class to which most members' tenants belonged, and a consequent reluctance to tax them [4]

The view that tax contributions should be assessed in accordance with ability to pay was thus never completely overthrown, but for a large part of the eighteenth century

[1] The use of the term "excise" in this restricted sense appears to date from 1643, when both the type of tax and the name were taken over from the Dutch In the United States the more general use of the term previously customary in England continued in use, cf *O E D*

[2] As expounded in the Treatise on Government, 1690

[3] For instance, the almost contemporary philosophy of Hobbes put forward a "functional" view of the State, according to which the poor should be exempted from taxation on account of the value of their work, which formed a sufficient contribution to the body politic

[4] The Parliamentary storm which arose over Walpole's attempt in 1726 to substitute excises for the degenerated General Aid illustrates this attitude On grounds of the utility criterion Walpole's plan was better than it sounds, cf Chapter X, especially Sections 3 and 6

the flame burnt less brightly than at any other period of our fiscal history Nevertheless, about the middle of the century, when the strain on the revenue was eased, the taxes imposed were in fact less regressive Excises on commodities in general use were reduced to very low rates, and greater reliance was placed on high-rate taxes on luxury goods The eighteenth century approved of such taxes not merely because distributionally they were more acceptable but also because they regarded them as to some extent optional, the manner in which he would make his contribution to the revenue might in some sort be left to the discretion of the taxpayer Only an age of light revenue needs could have failed to realize that services cannot be paid for by optional taxes

Towards the end of the century, when the needs of the revenue were once more expanding, new taxes were again required This time the choice fell on a series of external indications of wealth, such as the number of hearths or windows in houses Such things were easy to assess, and ownership might be assumed to be roughly proportional to wealth These taxes undoubtedly represented a return towards the old tradition The small houses were completely exempt, and the window tax was even assessed at slightly higher rates as the number of windows increased

At the end of the eighteenth century there set in a period of severe financial strain similar to that which had occurred a century previously Once again tax ideals were thrown overboard in a scramble for revenue Excises of all sorts were introduced, and continued in operation throughout the Napoleonic wars They were once again condoned as a war necessity, but it is not improbable that they served something of the same function during the war as the purchase tax of 1940, in restraining consumption which would have been in competition with the war effort

The imposition of the new excises on top of the hearth and window taxes, the remains of the "optional" taxes, and various other remnants from earlier ages, reduced the tax structure to the utmost confusion Owning mainly to the degeneration of

the old taxes, up to 1797 the revenue was never sufficient to cover more than a minimum satisfaction of the primary collective wants and the interest on new war borrowing The persistent prejudice against the inequity of general taxes on wealth (as they had so far been imposed) prevented any solution from being found, until Pitt finally succeeded in persuading Parliament to return to the general taxation of wealth in the form of an income tax

Pitt's income tax of 1797 was enormously more effective than any previous general tax It produced revenue above expectation, and what was still more remarkable, instead of degenerating after a few years in the manner of all previous general taxes, the longer it was in operation the more revenue it produced This was no doubt partly due to the rise in money incomes during the war, but it also revealed a new efficiency in the revenue authorities [1]

Like the earlier general taxes, the income tax aimed broadly at an impartial proportionality in distribution, but it took definite cognizance of family circumstances by a system of rebates, and the lower incomes were assessed at a reduced rate Returns of income were not compulsory, but declarations had to be made in order to claim these allowances These returns were a substantial aid to correct assessment, and still more important, they formed a precedent for the later compulsory returns, which as experience has abundantly shown, are a *sine qua non* of an equitable and effective income tax

In spite of its greater efficiency, the generality of the income tax was still suspect It did not succeed in catching the profit incomes adequately, and the main burden still fell on land This was one reason, perhaps the main reason,[2] for the

[1] The main explanation of the new efficiency was that for the first time the government succeeded in training a reliable and effective staff of tax collectors The nucleus of this specialist organization was jealously and secretly preserved by Somerset House during the suspension period In all this it seems to be to Addington rather than to Pitt that the praise should be given Cf Hope Jones, *cit* and Shehab, *cit*

[2] There were also loud outcries against the inquisitorial methods of the tax collectors, this would mainly affect the profit incomes, so it is possible that they were not so undertaxed as the landlords believed.

opposition which it aroused, and which led to its suspension early in the reconstruction period Although the first income tax vanished in 1816, and every effort was made to obliterate its traces, few people believed that it would not return The door had once more been opened wide on the old tradition of taxation in accordance with ability None of the Victorians seriously questioned its validity, although they inherited from the eighteenth century the partially contradictory principle that all should contribute to the expenses of government It is only in the most recent period that these two ideals have been successfully reconciled

§ 3 **The Subsidiary Aims of Taxation** Once the income tax was gone, the tax structure inevitably sank back into something like its eighteenth-century distribution Thus, in 1828, over 70 per cent of the revenue came from Customs and Excise, over a quarter being derived from duties on food and non-alcoholic drinks, and a considerable part of the rest from excises on bricks, glass, hides and other commodities which certainly affected wage earners This tax structure probably bore at least as heavily on the poor as that of the late seventeenth and early eighteenth century, but it differed from it in an important manner, in respect of the subsidiary aims to be achieved by the revenue It will be convenient to turn aside to discuss the change of opinion in this respect before proceeding to trace the modern development of the distributional ideal

From the middle of the seventeenth century an increasing desire to serve economic ends by differential import and export duties is discernible At first the main objective was to encourage the import, and discourage the export, of raw materials which might serve to stimulate employment at home Gradually, the direct protection of home industries and the encouragement of exports came to attract more attention In the eighteenth-century period of revenue ease Parliament was able to experiment with differential duties designed to reach the "productional optimum" by favouring particular interests As usually happens, many of these attempts over-reached themselves

A striking example of an unlooked-for consequence of the encouragement of industry by the State was the effect on the home production of alcohol of an import duty In the eighteenth century the protection afforded to the manufacture of spirits[1] resulted in such an enormous increase of output, and fall in prices, that the spread of gin drinking among the working class alarmed and shocked the whole country (It was a case, as the phrase went, of "drunk for a penny, dead drunk for tuppence") The result of this fiasco was the inauguration of the now traditional British policy of drastic excises on intoxicants, with the express purpose of reducing consumption Already in 1828 a third of the revenue was derived from alcohol and tobacco (the latter duties had also something of a sumptuary purpose) As we have seen, this policy has been continued without intermission right up to the present day, not, as must be acknowledged, without considerable advantage to the revenue

Of greater economic importance were the duties imposed on imports, with the purpose of protecting the balance of payments It would seem that in the latter half of the eighteenth century a severe strain was felt on the exchanges, this manifested itself in a series of crises, and in high and fluctuating interest rates The causes of the pressure were complicated, they were compounded partly of the strain of successive wars, partly of the weakness of the Dutch exchange (due to the gradual impoverishment of that country) and the consequent efforts of Dutch nationals to repatriate funds hitherto invested in England

The customs duties with which the eighteenth century attempted to meet this trouble were clumsy and no doubt inefficient Adam Smith viewed the tax structure of his day with great disfavour, and no doubt he was right in believing (in effect) that the innumerable duties and subsidies seriously distorted the allocation of resources, and so hindered the approach to the productional optimum In principle Pitt was

[1] The motive behind this policy was as much antagonism to the import of French wines as protection of home industries Among the upper classes it led to the substitution of port for claret

also in favour of tariff reduction, but during the war period the state of the exchanges did not allow of any relaxation, indeed the suspension of cash payments by the Bank of England signalled the final collapse of the balance of payments

Not long after the end of the war, however, Huskisson was able to effect an enormous simplification of the tax structure without any appreciable loss of revenue This was a reform entirely in line with Smith's doctrine, but it also paved the way for the later reduction of duties on the path to free trade Nevertheless the repeated exchange crises of the early eighteenth century, and their obvious relation to abnormal food imports (consequent on bad harvests at home), reveal that the balance of payments remained precarious until near the middle of the nineteenth century It is probable that the most important economic effect of the Corn Laws was their restriction of imports

From the 1860's the balance of payments was never in serious danger until after 1925 The Victorians, accustomed to rapidly expanding markets and to an unprecedented rate of capital accumulation, looked back incredulously at an age which had thought it sensible to multiply customs duties, and even to attempt to prevent the export of coin In our own times, faced again with a deterioration in the balance of payments, we may look more kindly on an age when governments had to meet a very difficult international situation with whatever clumsy and primitive weapons lay to their hands

Although the successive repeal of protective duties (culminating in that of the Corn Laws in 1846) led eventually in the circumstances of the mid-nineteenth century to a substantial increase in the national income and in the standard of living, it entailed for the time being a serious loss of revenue, which sooner or later would have to be made good Reluctantly it was realized that this implied the return of the income tax Thus it was that in 1842 the income tax came back, on the strict understanding that it was a temporary reserve for emergencies It was soon perceived, however, that many of the old objections to it had lost weight Partly owing to the

increased skill of the Inland Revenue, partly to the rising morality of the business world, the assessments could no longer be accused of partiality Gladstone continued to the end of his days to affirm that the income tax was only temporary, but the fact remains that when he might have abolished it he refrained from doing so

§ 4 The Acceptance of the Progressive Principle The principle that a substantial part of the revenue should be raised by means of a tax which paid prime attention to ability to pay was thus firmly and finally established The remaining stage of interpreting "ability" as satisfied only by progressive taxation was delayed for a few more decades Sir William Harcourt's progressive death duties of 1894 was the first step along the new road, but the tax structure as a whole remained strictly proportional up to the second decade of the twentieth century Yet the concept of progressive taxation, and the policy of bringing about a more egalitarian distribution of income through public finance, were no more than logical extensions of the traditional tax ideals It is possible to trace the gradual emergence of the modern outlook from at least an early stage in the nineteenth century

Up to the end of the eighteenth century the progressive idea (if we can call it such) was confined to the (very persistent) attempts to lighten the tax burden of the working class The choice of excises falling outside the range of working class purchases, and the exemption limits of the hearth and window taxes, are illustrative of these attempts In the "reduced rate" on small incomes of the early income tax, it is perhaps possible to detect a small further step, historically it did prove to be the first link in the chain of a fully progressive income tax [1] This tenderness for the poor was based on humanitarian grounds, and was not supported by logical argument, indeed there was a total failure to produce any argument which could stand up to Locke's contention that all should contribute to the expenses of the State

[1] Cf p 184

About the turn of the eighteenth century, however, economists were arguing that the poor should be exempted from taxation on strictly economic grounds. Since (by common assumption rather than by factual demonstration) the poor lived on the margin of subsistence, any rise in prices, such as that due to the taxation of commodities which they purchased, would drive them below the margin. If employers did not increase wages to compensate for the tax, the supply of workers would decline. In either case British production costs would rise and our international competitive position would be damaged. It was an argument that no doubt reflects the unfavourable terms of trade of the early nineteenth century, but it did provide a logical basis for the many who wished to treat the poor generously on humanitarian grounds.

On the whole Adam Smith reflected the eighteenth-century point of view in being relatively uninterested in distributional questions,[1] yet it is evident from other parts of his book that he was extremely interested in welfare problems. It is probable that in his view progress towards the "productional optimum" (which would be fostered by a reduction in restrictive duties) would improve the lot of all more rapidly than conscious redistribution. Among his contemporaries, however, there were already some who demanded that taxation should be used "to remedy the inequality of riches as much as possible by relieving the poor and burdening the rich".[2]

By the middle of the nineteenth century such a leading economist as Mill was prepared to support progressive taxation so long as the object could be obtained without taxing "industry and economy". He was apprehensive of the effect of a progressive income tax on investment (a very real danger in the days of small scale private business), but he was in favour of the taxation of economic surplus (Ricardian rent), and also of

[1] But he was prepared to go so far as to say "it is not very unreasonable that the rich should contribute to the public expense, not only in proportion to their revenue, but something more than in that proportion". (*Wealth of Nations*, Book 5.)

[2] Lord Kames, *Sketches of the History of Man*, quoted in Cannan's edition of the *Wealth of Nations*.

progressive inheritance taxes The first of these two alternatives was immediately recognized as being economically admirable Since pure surplus arises as the result of forces outside the control of the individual (such as the increased demand for his labour or for the use of his property) he can have no incentive to reduce his output if the surplus is taxed away Unfortunately, the revenue to be gained from taxes on pure surplus is in most circumstances negligible in relation to the costs and difficulties of assessment and collection [1]

Largely owing to Mill's support, the progressive inheritance tax became law in 1894 By that time it is clear that some degree of progressive taxation had become generally acceptable Many Liberals would probably have been prepared for a progressive income tax almost immediately [2] The change in outlook owed much to the marginal analysis of the 'seventies, and its demonstration that an accurate interpretation of "ability" must take account of the fall in the marginal significance of money as income rises, so that even an "equal sacrifice" of income called for progressive rather than for proportional taxation

A few years after Harcourt's death duties had been introduced Edgeworth was arguing[3] not for "equal sacrifice" but for "minimum aggregate sacrifice"—which strictly interpreted would have implied the confiscation of all incomes over a defined level Since both these principles required the interpersonal measurement of utilities, they were not capable of providing an objective criterion for the direction of policy (such as is provided by the modern utility criterion) Nevertheless, the general acceptance of the principle of the redistribution of incomes through public finance—which was well on the way by the end of the nineteenth century—owed much to the contemporary discussions of the economists

[1] Cf Chapter XI, Section 4

[2] Harcourt actually prepared a scheme for a progressive income tax in 1894, but withdrew it, as he thought it would be going a little too fast for Parliament, cf A G Gardiner, *Life of Sir William Harcourt*, Vol II, Chapter XVI

[3] *E J*, 1897, reprinted in *Collected Papers*, Vol II

At the beginning of the twentieth century it would not have taken a very well-informed prophet to foretell that the next substantial strain on the revenue would see the establishment of the progressive income tax The occasion came with the Liberal Budget of 1909,[1] which called for large additional funds (to finance additional naval expenditure as well as new social services) Thus supertax[2] finally found its way into the tax structure, in 1913 it yielded £3 mn, by 1920 this had already jumped to nearly £56 mn

Realization of the redistributional potentialities of public finance was greatly facilitated by a new way of looking at taxes which is first discernible in the Gladstone era Instead of regarding each tax separately, and attempting the impossible task of choosing only those taxes which would pass all the tests, it was suddenly realized that any desired distributional result could be obtained by a compensatory structure of taxes, in which the faults of one would be offset by the virtues of another It followed logically (although this was only later realized) that expenditure should also be taken into account, or at least so much of it as satisfied wants other than the primary collective needs

This discovery finally made it possible to resolve the dilemma between the principles that all should contribute to the expenses of government (on political and moral grounds), and that the poor should be exempt (on humanitarian and utility grounds) In Britain to-day working class families do contribute to the costs of government, in respect of income tax it is a fully conscious contribution Nevertheless on a balancing up of pluses and minuses there is a net redistribution[3] in favour of the lower income groups By appropriate alterations of the tax and expenditure policy the redistribution can be adjusted to whatever extent, or in whatever direction, is required by the criteria of policy

[1] It was the rejection of this budget by the Lords which led to the passing of the Parliament Act of 1911 (see p 44)

[2] The name was changed to surtax by Mr Churchill in 1929

[3] Cf Chapter XVI

CHAPTER IX

THE METHOD OF TAX ANALYSIS

§ **1. The Classification of Taxes** A necessary first step in analysis is classification, before we can begin the task of tracing the operation of particular taxes through the economic system we must divide them into convenient groups. In Chapter V we found that income tax and death duties are referred to as "direct taxes", most of the other taxes in the British tax structure are regarded as "indirect". The direct/indirect distinction has been by far the most commonly used classification, especially in Britain, for the reason that it was the one which has legal and administrative backing. For this very reason, taxes are not usually classed quite in this way in other countries, which have different institutions or methods of tax collection.

The essence of the British distinction between direct and indirect taxes lies in the relation between the taxpayer and the revenue authorities. Taxes for which liability varies with the circumstances of the taxpayer have to be separately calculated for each taxpayer, so that the relation between him and the revenue authorities is in principle a direct and personal one. For certain other taxes it is convenient to the revenue authorities to have the tax collected directly from the taxpayer by an official collecting agency, for others, however, it is simpler to make use of manufacturers or merchants as unofficial tax collectors, so that in that case there is no direct relation between the revenue authorities and the taxpayer.

Into the latter class fall those taxes whose liability depends on the amount or value of a particular product or service purchased, such as the tax on a packet of cigarettes or a seat at the cinema. What is really being taxed in this case is not the packet of cigarettes (which cannot pay a tax), but the

enjoyment of the consumer in satisfying his want of a smoke The enjoyment of goods which are not consumed in a single use, as cigarettes are (for instance motor cars or wireless sets), cannot, however, be taxed by making the merchant or manufacturer an unofficial tax collector, unless the government is content to collect tax only once in the lifetime of the goods, namely, when they are first sold Consequently, for this class of goods the revenue authorities need an official tax collector, who will collect a yearly sum during the lifetime of the goods, for the right to use them The British revenue authorities, naturally looking at things from their own point of view, like to regard as direct all those taxes which are either individually assessed on the taxpayers or collected from them by an official agency [1]

It is clear, however, that there is no essential economic difference between a tax on the enjoyment of smoking and a tax on the enjoyment of motoring, while, on the other hand, a great gulf separates a tax assessed on total income or capital, from a tax which is paid as a condition of satisfying a particular want, such as smoking It is largely immaterial in the latter case whether the taxpayer meets his liability by means of a single payment (as he must do in the case of a single-use good) or in the form of an annual right to use (as will probably be required in the case of a durable-use good) Again it is immaterial—from this point of view—whether the tax is assessed on a main component of the finished article (e g , tobacco) or on a subsidiary component (e g , the oil or labour used in manufacturing processes), in both cases the tax will have to be paid before the smoke can be enjoyed

There is thus a fundamental economic distinction between taxes on income (including taxes on the capital from which income is derived), on the one hand, and taxes on outlay—either for outright purchase or for periodic right to use—on the other This distinction is of universal validity, and does not

[1] For a further discussion of this, and other points in the present chapter, cf U K Hicks, "The Terminology of Tax Analysis," *E J*, April, 1946

depend on national institutions Its true importance has, however, only recently been recognized, because it is from calculations of the national income and of its distribution among the citizens that it derives its significance, and such calculations have only comparatively recently been officially recognized, and used as planning directives

The national income (or national output) is not a single or simple concept There are, in fact, two fundamental concepts of the national income,[1] both of which are set out in the White Paper, because both are of significance, although for different purposes In the White Paper these concepts are called respectively the National Income (Output) at Factor Cost, and the National Income at Market Prices The first is an objective, technical concept, the different commodities and services in the national income are valued according to the amounts of the factors of production which have gone to make them, the relative prices of the factors are taken to represent the rates at which the various factors are capable of being technically substituted at the margin, so that the cost of a commodity is taken to represent the amount of the nation's resources which have gone into making it The national income at factor cost is thus a measure of the technical potential of the national resources

The national income at market prices on the other hand is a subjective or welfare concept It reduces the different commodities to a common measure not according to their costs but according to their marginal utilities The relative amounts of different commodities and services which people buy represent the relative satisfactions which the members of the community derive from the components of the national income at a particular set of prices The product prices which consumers have to pay in the market are made up of the factor cost and the

[1] The same distinction holds good for the Gross National Product, which is merely the national income (or output) before depreciation of fixed assets and stock adjustments have been made In view of the difficult problems surrounding the estimate, and even the concept, of depreciation, the "G N P" rather than the net national income is tending to be used in policy formulations

outlay taxes which have to be paid before the satisfactions can be realized (Some market prices may be less than factor cost because the government awards a subsidy, this makes no difference in principle, the subsidy is merely a tax in reverse) Hence the difference between the factor cost calculation and the market price calculation consists of outlay taxes, less parallel (outlay) subsidies [1]

The market price calculation of the national income is thus a measure of the satisfaction which consumers derive at a given set of prices, and as concerns us more directly in public finance, when a statistical calculation is made of the distribution of the national income among the different income groups in accordance with their share in it, the outlay taxes which are paid as a condition of this share have to be imputed as accurately as possible between the different income groups, in accordance with the outlay of their incomes between different types of consumption In Chapter XVI we shall be examining the results of calculations of this nature

The distinction between income and outlay taxes is thus of great economic and social interest, but it does not bring out quite fully the distinction which we need for analytical purposes Let us recall a point which we reached in Chapter VII, when discussing the subject-matter of public finance Just as in general economics there are some problems which can best be approached from the standpoint of the individual firm or industry (by means of a "partial equilibrium" analysis), and others which call for a general analysis of spending, saving and investment, the factors which determine the size of the national income, so in tax analysis it is convenient to make a similar distinction even at the stage when we are working out the operation of particular taxes, and before we come to considerations of the combined effect of public finance in the economy

[1] It should be noted that subsidies can be divided on an exactly parallel basis to taxes, into those which give better value for a particular sort of *outlay*, by enabling consumers to purchase the product at less than factor cost, and those which provide a general subsidy to *income*, e g pensions, usually called social transfers For further discussion of this point see Chapter XVI

We can thus make an analytical distinction between *partial* taxes in which all or nearly all of the working out process takes place in a particular corner of the economic field (e g, in the industries concerned with the manufacture and sale of cigarettes and tobacco), and *general* taxes which impinge directly on the phenomena which determine the size of the national income

It should be emphasized that this analytical distinction is essentially one of convenience, not of logic In practice a partial analysis is appropriate and sufficient for nearly all outlay taxes, while for income taxes it is completely inapplicable, but there may be some outlay taxes which are of such transcending importance in the economy that they require a general analysis, or they may require one if we are interested in long period problems when the operation of the tax will have spread beyond the confines of the markets first affected [1] A different form of analysis may conceivably be appropriate to the same tax under different social conditions Thus it would have been perfectly logical for an economist of the early nineteenth century to apply a general analysis—such as Ricardo would have given—to a tax on bread, emphasizing its probable effect in driving the worker below the margin of subsistence, whereas to-day we should regard a tax on bread as not essentially different from a tax on tea, in which we should certainly not be concerned with changes in the size of the national income

§ 2 **Searching for the "Taxpayer"** The problem of classification thus leads directly to the method of analysis In the past it has been customary to set out on the process of tracing the operation of a tax through the economic system from the starting point of the party who is in contact with the revenue officials For instance, in the case of a tax on smoking, this is the tobacco manufacturer who pays the duty on the tobacco leaf as he withdraws it from bond, in the case of the British purchase tax it is the wholesaler, since it is on this stage of the productive process that the revenue authorities have found it

[1] Cf Chapter XIV, especially Section 3

most convenient to pounce, in the case of an income tax, however, the process of analysis can only start with the taxpayer, the owner of the income, since he alone is concerned

Following this method of approach an elaborate theory of "tax shifting" has been built up [1] To take a simple example, it would be necessary to say that the tobacco manufacturer shifts the tax to the wholesaler, who shifts it to the retailer, and finally to the smoker The object of this analysis has been to discover whether the price of the finished article is raised by as much—or more—or less than the amount of the tax It reflects the view of the revenue official rather than of the economist It is certainly not the way the Chancellor of the Exchequer looks at the matter, since he regards himself as taxing smokers, nor is it the view of the smoker himself, since he fully realizes he will have to pay the tax as the price of his indulgence

While this approach does not necessarily vitiate an analysis if it is properly conducted, it is unnecessarily clumsy, and in practice it has not usually led to happy results, for several reasons In the first place having taken so long to discover the "real" taxpayer (e g , the smoker) there has been a tendency to break off the analysis at that point, just where it ought to be becoming interesting Secondly, it has unduly narrowed the range of vision, not even quality changes (which are just as likely as price changes) can conveniently be allowed for Much more fundamental, however, it is not price or quality changes as such which are important or interesting, but their causes—the degree of monopoly which a given price rise implies—and their consequences—the effect on taxpayers of having to alter their consumption schedules, and on producers in the industries concerned, of having to reallocate factors to take account of the new economic situation created by the tax change

Finally, it has sometimes been attempted by analogy to develop a parallel theory of the shifting of income tax by attempting to trace changes in product prices which might be

[1] Cf especially E R Seligman, *The Shifting and Incidence of Taxation*

due to income tax payers trying to hand on the tax[1] As we know, it is only outlay taxes, and not income taxes, which are included in the prices at which goods exchange on the market, consequently the search must be vain More than that it is fundamentally misconceived, the operation of income tax is on the level of incomes, not on the level or prices[2]

In view of all these difficulties, when we come to analyse the operation of taxes we shall always start with the "real" taxpayer—in the case of income and capital taxes with the owner of the income or capital, in the case of outlay taxes with the party who, by his choice of purchases on the market, determines the difference between the national income at factor cost and the national income at market prices

§ 3 **Formal Incidence and Effective Incidence** Recalling the steps in our discussion, it will be seen that we are concerned in economics with two concepts of the falling of taxes on taxpayers, or as it is called, the incidence of taxes In the first place there is the statistical calculation of the way in which the revenue collected from any particular tax over a given period (usually a year), namely, the difference between the factor cost and the market price of the product on which the tax is assessed, is distributed between the citizens (for convenience grouped according to their income levels), or, alternatively, the proportion of people's incomes which goes *not* to provide the incomes of those who furnish them with goods and services, but is paid over to governing bodies to finance collective satisfactions The result of this calculation may be called the *Formal Incidence* of the tax—or if we add up the distribution of the revenue from all taxes, of the tax structure The calculation of formal incidence is of great social interest in

[1] *Report on National Debt and Taxation*, Cmd 2800 of 1927, p 108, and Minutes of Evidence

[2] This is not to deny that in certain circumstances—which must be regarded as exceptional—such for instance as a sellers' market with a complacent monetary policy, income tax may be "shifted" by producers raising their selling price to cover *estimated* liability to profits taxation, or more plausibly by raising wages to compensate workers for a rise in personal income tax rates

connection with questions of the distribution—and redistribution—of income, it is also of economic importance to the government when planning the national output in order to maintain a high level of economic activity, since it assists them to predict for instance whether the reaction to a given tax change will mainly take the form of a restriction of consumption or of a reduction in saving These are questions which we shall have to discuss in Part III, especially in Chapter XVII

Important as it is, however, the calculation of formal incidence tells us nothing directly of the taxpayer's reaction to a change of tax, and its consequences, it is precisely with these questions that the second concept of incidence is concerned In order to discover the full economic consequences of a tax we have to draw and compare two pictures—one of the economic set-up (distribution of consumers' wants and incomes, and allocation of factors), as it is with the tax in question in operation, the other of a similar economic set-up, but without the tax It is convenient to call the difference between these two pictures the *Effective Incidence* of the tax It will be seen that it must often be a very complicated picture, and moreover, since both situations cannot exist together, one of the pictures must be hypothetical, established by reasoning and not by observation

The establishment of effective incidence thus calls for a systematic chain of reasoning, based on observation of such factors as demand, cost and marketing conditions (in the case of outlay taxes), and as the distribution of income and wealth, the degree of industrialization and the typical size of the firm (in the case of income taxes) Wherever possible the reasoning should naturally be supported by statistical evidence, but owing to the complication and interrelation of many of the factors concerned, statistical evidence can hardly be more than a support for the deductive process It is only when this chain of reasoning has been carried through in respect of each category of tax that we can be in a position to state which taxes are to be preferred, and which avoided, from the point of view of the criteria of policy [1]

[1] For further discussion of these distinctions see Chapter XVI

CHAPTER X

THE INCIDENCE OF PARTIAL OUTLAY TAXES

§ 1 **Types of Outlay Taxes** If we were to take a look round at the tax structures of the world, at any time we should find everywhere a large number and considerable variety of partial taxes on outlay in force, if we took a look into the past we should find, if not a still larger number, at least a higher proportion relatively to income taxes, than at present The first reason for this popularity of outlay taxes is that they are extremely simple to collect, consequently, they can be a success in primitive conditions where elaborate revenue machinery is out of the question, this is especially true if they are imposed on imported goods of a type which cannot be produced at home More recently advantage has been taken of the fact that they yield revenue extremely quickly—it begins to flow in from the day the tax is imposed—to check inflationary pressure

In spite of these conveniences, on the whole the importance of outlay taxes relatively to income taxes is tending to decline, for the reason that their income distribution is less satisfactory on modern standards, as we shall see later, outlay taxes are always more or less regressive measured against total incomes Nevertheless outlay taxes are still a considerable item in all tax structures, and they have a not unimportant part to play in the combined fiscal planning of the future Consequently, it is necessary to trace their effective incidence with some care, in spite of the complications into which the process will inevitably lead us, complications which are only partially due to the varieties of tax which may be imposed, and much more importantly to the differences in demand, cost and marketing conditions, which exist in the industries whose products are convenient subjects for taxation

In the first place it will be convenient to look briefly at the different forms which outlay taxes may take Partial outlay taxes may be imposed either on single-use goods (i e, those used up in a single process of consumption or production) and on services, or on durable-use (capital) goods, used either in consumption or production They may be imposed on an isolated commodity (e g, tea), on a group of closely related commodities or on a wide range, as in purchase tax Taxes imposed on the use of capital goods may take several different forms They may be assessed on the value of the goods—either on capital or on annual value—or alternatively they may take the form of an annual licence to use the goods—either for any purpose of which they are capable (e g, wireless licences) or for a particular purpose (e g, liquor licences for the sale of intoxicants)

If the licence implies more than a nominal restriction of use—if it is not granted freely on payment of the fee—then it acts as a protection to the taxpayers to whom it is awarded Outlay subsidies may in principle be awarded by any of the methods used for taxes, or again a tax and a subsidy may be used in conjunction to bring about a desired end, as the production of home-grown sugar has been fostered by a beet sugar subsidy combined with a differential duty on the imported product

Liability to a tax assessed on the use of particular goods naturally varies with the quantity of goods used, it may also vary with the quality of the goods, or with their price When the rates of tax are expressed as proportions of the selling prices of the goods, the tax is described as *ad valorem*, when it does not so vary, but is expressed as so much per lb or per barrel, it is known as *specific* Specific taxes may, however, be graded with the quality of the product, as for instance British motor vehicle duties used to vary with the size of the engine

Specific taxes are much easier to administer than *ad valorem* taxes, which may require a very expert revenue department if it is a question of converting prices from the currency of another nation Owing to the endless possibilities of rate manipulation where this has to be done, *ad valorem* taxes are in favour as a

protective measure, indeed they are the cause of most of the administrative friction which arises between nations over tariffs Specific taxes are rather less productive of revenue than *ad valorem* taxes, and also tend to be rather more regressive, but this disability can largely be eliminated by a system of grading It is worth noticing that when a general rise in prices takes place, the real rates of specific taxes are reduced, while those of *ad valorem* taxes are automatically adjusted A considerable part of the rise in the rates of British outlay taxes between 1914 and 1931 can be regarded as a compensatory adjustment in specific taxes

In the United States the typical partial outlay tax is *ad valorem*, in Britain the specific type has been traditional, and is still the most usual A very wide use is made of grading, however The new protective duties of the inter-war period, both those introduced in the 1920's and those which came in with the big change of policy in 1931, are assessed on the *ad valorem* method,[1] so also is the purchase tax The local rate, which brings in more revenue than any other outlay tax, also belongs to the *ad valorem* group, although present valuation practice does not lead to a very close correspondence between rents and rateable value

§ 2 **The Incidence of Taxes under Perfect Competition** The general sequence of the operation of a partial tax on outlay is that first, the selling price of the product is increased by the tax, this leads to a restriction of demand, so that sooner or later production must also be cut down In the case of taxes on single-use commodities the analysis can usually be confined to following the ramifications of this process, in the case of taxes on capital goods, however, there is an additional chain of events to consider, due to the fact that capital values will immediately be adjusted to a change in the rate of tax In the present chapter we may avoid this complication by confining our attention to taxes on single-use goods

[1] A variety worth noticing is illustrated by the duties on imported silk which vary with the stage of manufacture, being highest on finished goods

In the normal case it makes very little difference in principle whether the tax is imposed on consumers' or on producers' goods[1], this can be demonstrated very simply (Fig 1) In order to start with as few complications as possible, we may assume that perfectly competitive conditions prevail in the industry making the taxed commodity (in the sense that a change in the output of a single producer would make a negligible difference to total output), and further, that there are no closely related products or industries

In Fig 1, SS and DD are market supply and demand curves, in the usual Marshallian sense Under perfectly competitive conditions A is then a position of full and stable equilibrium If now a tax of dimensions E*a* is imposed, the new equilibrium point will be *a*, whether the tax is assessed on producers (and the supply curve raised to S′S′), or on consumers (and the demand curve lowered to D′D′) In all normal demand and supply conditions *a* will lie above and to the left of A, consumers will have to pay more per unit, and will consequently buy less, producers will have to charge a higher price including tax, and will consequently sell less The amount sold will be

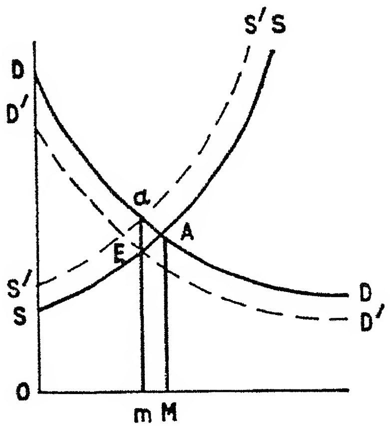

FIG 1

[1] The productional stage at which a tax is imposed may be of importance in other connections A tax on a raw material or on a semi-finished product encourages producers to use it economically, this may be of considerable importance where the material in question has to be imported Again, the earlier the stage of production at which the tax is imposed, the greater the opportunity for "pyramiding" by adding a percentage to price at each successive stage of manufacture, see p 151

reduced from OM to O*m*, and the price raised from MA to *ma*. The analysis can be applied in reverse (by lowering the supply curve or raising the demand curve) to fit the case of a subsidy.

It is evident from the diagram that the operation of taxes and subsidies of this nature is a marginal phenomenon; they fall directly on margins of production and spending—spending in general as well as in this particular direction—and so also on saving margins. As between the margins of production and consumption respectively, the direction and extent of the economic readjustments which have to be made as the result of a change of tax depend on the elasticity of demand on the one hand, and on the ease or difficulty with which factors can be transferred to (or from) other uses, on the other.

As between margins of spending and saving, the result will depend, to an important extent, on the distribution of the consumption of the taxed (or subsidized) product between the different income levels. When most of the consumption comes from the lower income groups, which is normally the case since they comprise most of the population, the readjustment will largely take place at the expense of consumption; when an important part of the demand comes from the well-to-do, the tax may be paid out of saving to some extent.

It is obviously important for the government to be able to predict which margins will be most affected by a given change of tax or subsidy. On one occasion it may be necessary to restrict consumption; on another it may be desired to raise a given revenue with as little restriction of consumption as possible, or to reduce saving. When a tax is imposed on a commodity which figures in only a limited range of consumption (e.g., sugar) an estimate of the formal incidence of the tax can fairly readily be made, and the effective incidence also is usually not difficult to predict. When, however, a tax is imposed on a factor or a commodity which is common to a very wide range of consumption (e.g., fuel), there is considerable difficulty in establishing even formal incidence, and the course of effective incidence cannot satisfactorily be traced.

The real objection to such taxes "on production in general",

as they are sometimes called, is not that they are taxes on production while the others are taxes on consumption—as we have seen all partial taxes fall both on consumption and on production—but rather that, on account of the uncertainty of their incidence, they cannot be fitted into any rational fiscal policy This is equally a disadvantage whether we are thinking of a programme of income redistribution, or a plan for maintaining a high level of economic activity Similarly, it is impossible to give a rebate in respect of them on goods intended for export, so that such taxes have the effect of raising export prices

§ 3 **The Theory of Surpluses** Returning to the case of a tax whose incidence falls mainly on a single line of consumption, it is apparent from Fig 1 that the rise in price as a result of the tax will be large or small relatively to the change in output, according as the demand curve is more, or less, elastic If the demand curve is very elastic the sales of the commodity rather than its price will be mainly affected, with relatively little inconvenience the consumer can satisfy his wants in some other way, the tax is for him, in a sense, optional

It was this seemingly optional nature of taxes on consumable goods which commended them to the eighteenth century, as much as their "convenience" (in the sense of being paid almost unconsciously by the taxpayer), and their "economy" (in the sense of requiring no expensive revenue machinery, at any rate so long as the rates were not so high as to encourage smuggling) It cannot be denied that there is some convenience to the taxpayer to have a tax which can be paid gradually over the year, and which consequently does not require him to set aside a large cash balance to meet an annual or semi-annual liability, as has traditionally been necessary for income tax, but this disadvantage of income tax can be overcome by deducting the tax from the income before it reaches the owner of the income With modern administrative technique outlay taxes no longer have as great advantages in convenience of collection, relatively to income taxes, as they used to have

Since governments must have revenue, the "convenience" of the optional nature of outlay taxes is an illusion, it is illegitimate to compare the "inconvenience" to the taxpayer of a tax which he does not have to pay with the inconvenience of one which he cannot get out of The correct comparison is between the relative damage to consumers and producers, in the sense of their loss of satisfaction, consequent on raising a *given* revenue by different methods If we make this comparison we shall find that the eighteenth century conclusion may be quite misleading

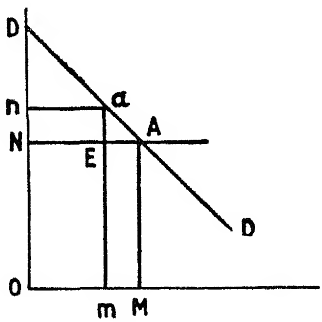

FIG 2

In order to concentrate on the essential factors, let us start with a situation in which costs are constant (Fig 2), maintaining our previous assumptions of perfect competition and absence of closely related products or factors Before the tax is imposed an amount OM of the commodity is consumed, at price MA When a tax of amount E*a* is imposed, it will bring in a revenue N*na*E, but there will be a loss of consumers' surplus equal to the triangle *a*AE,[1] in the sense that if the government tried to compensate taxpayers for their loss of satisfaction out of the revenue, there would not be enough to go round

There is thus an initial grave objection to partial taxes on outlay on welfare grounds, in that they cause a net difference between taxpayers' loss and revenue's gain, a flagrant violation of Adam Smith's principle of "economy" correctly understood There is thus, on welfare grounds alone (e g, apart from

[1] If the tax is a small one it is quite reasonable to follow Marshall's identification of the demand curve and the utility curve, by assuming the marginal utility of money constant, but the demand curve can equally well be replaced by a marginal indifference curve, so that "income effects", if any, can be allowed for Cf J R Hicks, "The Four Consumer's Surpluses", *Review of Economic Studies*, Vol XI, No 1

distributional questions), an *a priori* case against partial outlay taxes Marshall and Edgeworth would have regarded this as a case *for* income taxes, but we shall see later that this argument is less convincing when the rate of income tax is high

Clearly some outlay taxes will cause a greater loss of surplus than others, we must therefore investigate more closely on what the loss of surplus depends If we assume that the triangle aAE is rectilinear (as is reasonable for a small tax), the loss of surplus—the area of the triangle—is equal to half the reduction in the amount consumed, multiplied by the tax per unit of commodity, while the revenue collected is equal to the rate of tax multiplied by the amount spent on the commodity, post-tax We can see further that the loss of surplus will vary relatively to the revenue collected—in the same proportion as half the change in amount consumed bears to the total consumption after tax

$$\frac{\text{loss of surplus}}{\text{revenue collected}} = \frac{1}{2}\frac{m\text{M}}{\text{O}m}$$

It will be observed that the right-hand ratio is equivalent to half the elasticity of the demand curve multiplied by the ratio of the amount of tax and the amount spent

$$= \frac{1}{2}\,\frac{\text{elasticity of demand} \times \text{revenue collected}}{\text{amount spent}}$$

Hence, we can write the loss of surplus

$$= \frac{1}{2}\,\frac{\text{elasticity of demand}}{\text{amount spent}} \times (\text{revenue})^2$$

This is a formula of great importance, because in many cases is should be possible to estimate the magnitudes concerned with a fair degree of statistical accuracy In practice, however, the situation will often be complicated by the fact that marginal costs are not constant, and we have therefore also to take account of the elasticity of the supply curve, and of the loss of producers' surplus (e g , the amount which would be needed to compensate the owners of the factors of production

employed in this industry for loss of earnings, if the industry were to be cut down, and they were forced to transfer elsewhere) In this case (cf Fig 3 where rising marginal costs are shown), the loss of surplus (aAE) is

$$\frac{1}{2}\,\frac{ee'}{e+e'}\,\frac{(\text{revenue})^2}{\text{amount spent}}$$

where e is the elasticity of demand and e' is the elasticity of supply

From this analysis it follows that for a given revenue the loss of surplus will be larger, the larger is the elasticity of either demand or supply, if either is completely inelastic the loss of surplus falls to zero, and there is no tendency to substitute any other good for the taxed commodity, the outlay tax becomes equivalent to a lump sum taken from the taxpayer or an income tax which has no effect on his willingness to work, in all ordinary circumstances, however, there will be some loss of surplus This loss will also vary (this time inversely) with the amount spent on the article, i e, its importance in consumption For to raise a given revenue from an "unimportant" commodity, very high rates of tax may be required, with any normal elasticity of demand or supply the loss of surplus will be severe

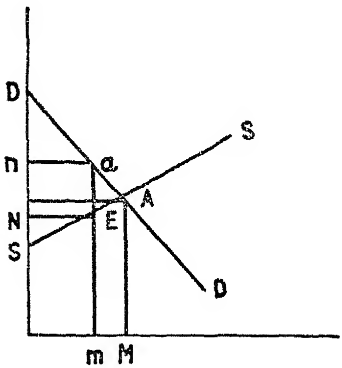

FIG 3

From this analysis it follows further that if any important commodity can be found whose supply or demand is completely inelastic, it will minimize loss of surpluses to raise all, or as much as possible, of the revenue by means of it [1] As long as either of the elasticities is very low, although not absolutely

[1] Cf Hotelling, "Edgworth's Taxation Paradox and the Nature of Demand and Supply Functions," *J P E*, October 1932

zero, it will still be advisable to tax the commodity concerned heavily, if it is desired to raise a given revenue from outlay taxes

This is the rationale behind the contention that a country should finance its public services by a single tax, on land Although the supply of land is very large, and may be taken to be completely inelastic, even a tax which absorbed the whole value of the rents from land would go but a small way towards financing the needs of modern governments The rents of buildings clearly could not be included, since their supply is anything but inelastic There are problems here to which we must return when considering the taxation of capital goods [1]

It must be emphasized that these conclusions refer only to the single question of loss of surplus In practice, distributional, and perhaps other economic or administrative, questions may also be important Apart from its more general applications, however, the analysis does provide an accurate and practicable method of choosing between different outlay taxes, particularly between those whose income distribution in consumption is similar, and where consequently no clear directive on distributional grounds exists

§ 4 **Taxation under Monopoly** So far we have assumed that perfect competition prevails in the industry making the taxed commodity Before turning to the vast hinterland between competition and monopoly which in the real world includes the greater part of the industrial field, it will be convenient at once to pass to the further boundary, and to discuss the case of pure monopoly, without related products or factors A situation in which there is a single seller of a commodity not very closely related to others may very well occur locally, and even persist for a considerable period, even when there are no "natural" monopoly elements in the situation, so that the analysis covers a wider field than might appear at first sight

[1] The case for a proportional income tax can also be based on the above argument, but a progressive income tax requires a different basis of justification, see p 182

If the monopolist is maximizing his profits (as we must suppose) he must be making marginal revenue equal to marginal cost Hence any tax which increases the cost which he has to incur in order to put the marginal unit on the market will cause him to reduce his output and raise his price In any but the short period this is equally true of a tax which falls on his overheads and of one which falls on his running costs [1] The extent to which consumers will suffer depends on the monopolist's ability to increase his selling price without reducing his total profits on the one hand, or attracting rivals and so reducing his monopoly power on the other A great variety of results is possible, due both to the monopolist's exceptional power of manipulating his costs, and to his control of the market As Edgeworth pointed out many years ago, one of the drawbacks to taxing a monopoly is the uncertainty which surrounds the result

If we assume that the demand curve facing the monopolist is a straight line, and that the marginal costs of the monopolist are constant, it is clear from general monopoly theory that the price of the taxed commodity will be raised by *half* the amount of the tax, whereas under competitive conditions it will be raised by the whole amount of the tax [2] There seems to be no particular reason, however, to assume a demand function of this nature If there is some concavity in the demand curve, price will be raised by an amount greater than this, if the concavity is such that the marginal revenue curve and the demand curve are parallel over the relevant range, the rise in price will be equal to the tax, as in competitive conditions

If, however, we assume that the demand curve is not merely concave but of constant elasticity (which, at least for small

[1] Except in the case of a very firm monopolist, of what might be termed the 'Elizabethan type", in which the monopolist will be prepared to submit to almost any tax on overheads (say, a licence to produce), and his price and output policy will be unaffected by the tax In the traditional analysis too much has been made of this rather unreal case

[2] The situation can easily be visualized by interpreting the demand and cost curves in Fig 2 as belonging to a monopolistic condition, and comparing the result with the analysis accompanying Fig 2 For the full analysis cf J Robinson, *The Economics of Imperfect Competition*, pp 76ff

changes, would seem to be quite as probable as a straight line demand curve with constant slope), we get a much more serious result The ratio between price and marginal cost will then be constant, since marginal revenue is necessarily less than price, this must mean that the slope of the marginal revenue curve is *less* than the slope of the demand curve, so that the price will rise by more than the tax—as is indeed otherwise evident, for price is now equal to marginal cost (excluding or including tax) plus a fixed percentage, after the tax is imposed, the percentage is reckoned on a larger base figure This hypothesis[1] seems to be consistent with observed conduct of producers, it is just such an addition of a fixed percentage to profits at each productional stage, to cover the tax, which leads to the phenomenon of "pyramiding" of taxes assessed on the early stages of the production process

The economic importance of the monopoly analysis, however, does not depend on the existence of a few isolated monopolists who may be able to exert pressure on the community for limited periods, but on the vast intermediate field between the pure competition and the pure monopoly of the textbooks An important extension of the competitive analysis which we made above (cf Fig 3) shows that taxation of a monopolized[2] industry, when it leads to further restriction of an already restricted output, is more damaging to the *community* than taxation of industries where competition prevails

Let us suppose (Fig 4) that owing to monopolistic action, output in the industry which it is proposed to tax has already been restricted below the optimum position, by an amount MN, and surpluses correspondingly reduced by the magnitude

[1] For some unexplained reason Mrs Robinson in the passage quoted above does not extend her analysis to cover the case of constant elasticity

[2] That is to say under oligopoly as well as under pure monopoly In a situation of "imperfect competition" (in the sense that there is free entry into the industry, and changes in output are brought about by changes in the number of firms), although the price is greater than the marginal cost of the firm, it is the average cost of the firm which is the effective marginal cost of the industry, and this is not less than the price

of the triangle PAR If now a tax is imposed, price will rise to *mp* and output will be restricted to O*m* The loss of surplus is now measured (considering this industry alone), not by the triangle, but by the trapezium PR*r*, which exceeds the loss of surplus under perfect competition by an amount equal to the *whole* reduction in output to the tax, multiplied by the pre-tax gap between marginal cost and selling price

When we are considering a situation in which monopoly elements are present we have to be on the look-out for the possibility of product or factor relationship, in a way which is usually unnecessary in conditions of pure competition This circumstance may have an extremely important bearing on the question of the optimum allocation of factors between different industries

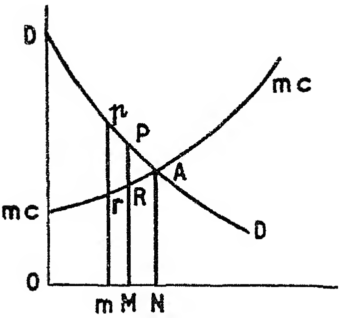

FIG 4

The fundamental social cost of monopoly is that it causes factors to be employed in such a way that the social output is less than it might be Instead of factors being employed in such a manner that in every use the value of the marginal unit of output is just equal to its cost, under monopoly the selling price of the product exceeds the cost of the factors to the industry, by a more or less considerable amount An extension of output in the industry might well result in a closing of this gap, and a consequent increase in the social income, but such an expansion will not take place as the result of economic forces alone, because (owing to the downward sloping demand curve), with every unit sold, profit declines Public action which tends to close the gap by bringing about an expansion of output will usually thus be a social improvement

The fact that the reorganization of industry in this manner would increase the social output indicates that the social cost of

keeping factors in an industry where their marginal product is less than it would be elsewhere is actually greater than appears, if we take account only of the private cost of the factors to this industry. In order to estimate the true social cost of the gap between selling price and the cost of the factors we have to value the latter, not at their private cost to this industry, but at the social cost to the community of their present utilization. Wherever there is a difference between the private and the social cost curves, there is a possibility that reallocation of factors can improve the social output.

§ 5 **Increasing and Diminishing Cost.** Marshall first drew attention to the possibility of successful public action in this connection by suggesting that industries with a rising cost curve should be taxed, and their surplus factors transferred by means of a subsidy to industries with falling cost curves. Assuming that selling price is equal to average cost (including rent) in both industries (which is Marshall's normal assumption), an increasing cost industry would be working under conditions of pure competition, while an increasing returns industry would exhibit some elements of monopoly. Since the increasing returns industry could employ more factors at prices that would cover their costs and yet sell the greater output at lower prices, the true social cost of retaining the marginal factors in the increasing cost industry needs to be adjusted upwards to take account of this lost opportunity. If the cost curve of the increasing cost industry were raised to its true social level the equilibrium point would be higher and more to the left than the apparent optimum (e.g., higher and to the left of A in Fig. 4), thus indicating that output in this industry has been carried too far from the social point of view. In the increasing cost industry there is thus a divergence between the private and social costs of the factors. Social output will be increased by a transfer of marginal factors to the increasing returns industry where no such divergence exists.

Although the Marshallian analysis is perfectly valid under its assumptions, it does not tell the whole of the story. Rising

costs may occur under monopoly as well as under pure competition If in any industry there is a gap between selling price and marginal cost, an extension of output in that industry will usually be a social improvement[1], but unless the whole of the rest of the economic system is working under conditions such that price equals marginal cost, there may be a divergence between the private and true social costs of the industry under consideration, so that action should not be taken to expand its output until the true social cost curve has been estimated, so that the correct target for the expansion can be ascertained

In thus ascertaining the cost curve of an industry whose expansion might benefit the community, two sets of factors need to be taken into consideration, first the extent to which additional factors can be supplied to this industry from unemployed resources, and secondly, the character and organization of other industries from which factors will need to be transferred So long as factors can be made available from unemployed resources, the expansion of the first industry is sure to be an improvement If a considerable part of the additional factors have to be drawn from other industries, careful attention must be paid both to the extent to which they are specific to their old industry, and cannot easily or cheaply be moved, and to the degree of monopoly in those industries from which the transfer can most appropriately be made The true social costs (or benefits) of contraction and expansion respectively in the various industries concerned must be

[1] The social cost curve of an industry which it is desired to expand or contract may also have to be adjusted to allow for external economies Thus an expansion in one industry may lead to an expansion of complementary industries, which were such that in them price was initially in excess of marginal cost In this case the social cost curve would be lower than the private cost curve of the industry in question This is a case of "Marshallian" external economies, depending on the existence of monopoly elements somewhere in the system, although the industry under consideration may be working in conditions of perfect competition External economies which depend on effects falling outside the private accounting system of the firm (cf p 109) may occur in a system of universal perfect competition, an appropriate adjustment of the social cost curve of the industry under consideration must also be made if they are present

weighed up against one another before the correct policy can be finally determined

Thus the conditions for the successful reallocation of factors by fiscal means include a knowledge of the technical conditions in all industries which are likely to be concerned in the transfer This knowledge, however, should not be of a sort which it is impossible for the government to obtain, but before a policy of this nature is embarked upon the effect of the additional taxes and subsidies on products already taxed should also be considered

§ 6 Intensification and Extension of the Tax Field So far we have discussed only the effect of a single tax considered in isolation, new taxes should also be considered in relation to those already in existence A policy of industrial reorganization through taxes and subsidies can soon lead to a multiplicity of new imposts, or to an intensification of those already in existence More generally it is important to determine how far an intensification of existing tax rates, or an extension of the range of taxes, will increase the loss of surpluses already suffered

Fortunately we can continue to apply the rule that we have established in this case also The tax which will cause least disturbance to consumption and production is that which from the taxpayer's point of view is as nearly as possible similar to a lump sum to be taken from him Where a group of commodities is being taxed this implies that the rates of tax should be so adjusted that consumption is cut down by the same proportion for each commodity It is probable, however, that some members of the group of commodities which it is proposed to tax are related to each other, either in consumption or in production, it may be as substitutes for each other or as complements (a rise in the price of one reducing the demand for the other) In this case we have to take into consideration not only the elasticity (of demand or supply) of any good taken in isolation, but also its "cross" elasticity in relation to its close substitutes or complements If the goods are very closely

related the cross elasticity between them may be more important than the straight elasticity of either considered in isolation

If a group of products or factors are related in such a way that a tax of the same rate raises the price of all the members of the group by the same proportion (as might approximately be the case with an *ad valorem* tax on products produced under conditions of perfect competition), the group can be treated as an economic unit from the fiscal point of view It follows that if we can find such a group of products or factors where the elasticity (either of supply or demand) for the group as a whole is very low, it will not merely do no harm to extend the taxed field to cover the whole group, it will actually minimize the loss of surpluses if as much of the revenue as possible is raised from the group This consideration should substantially widen the field in which partial outlay taxes can be made acceptable on welfare grounds

Further, our equations on pp 147–48 have shown that with a given elasticity of demand, the loss of surplus decreases as the amount spent on the commodity increases Hence, there is an *a priori* probability that the extension of a tax from one member of a group to another will decrease the loss of surplus, as compared with a policy of raising the same revenue from the taxation of the single commodity This may well be true even if the members of the group are not so closely related that they can be considered as a unit, it all depends on the relation between the elasticity of demand for the group and the elasticity of demand for the single product

If the article originally taxed has an elasticity near zero, but one of the group has a positive elasticity, then the elasticity of demand for the group as a whole will be positive, and the extension of the tax field would be a mistake On the other hand if we have two commodities which are *close* substitutes in the sense that a fall in the price of either sets up substitutional adjustments which are more at the expense of the other one than of other things in general, the elasticity of demand for the group of two *must* be less than for either article taken separately, so that the extension of the tax to cover both will

be a benefit. This will be true by a fairly large margin even if the relation between the two commodities is rather looser than we have been supposing.

This analysis holds good wherever the industries concerned are working under conditions of competition[1]—either perfect or imperfect—where consequently there is no substantial gap between price and marginal cost for the industry as a whole. If, however, conditions of monopoly (including oligopoly) prevail, we have to remember that there is a pre-tax loss of surplus (the consumers of the commodity are in a sense already taxed), so that the post-tax loss of surplus will increase at a faster rate. There is thus an *a priori* case against either extending the tax field to cover a commodity produced under conditions of monopoly, or to raising the rate of an existing tax on a monopoly. Consequently, the other arguments in favour of the change would have to be very strong in order for it to be desirable.

§ 7. **International Complications.** So far we have ignored the possibility that taxes may be imposed on goods imported from abroad, and that exports may be restrained by taxes or encouraged by subsidies. We must clearly take some account here of these possibilities, since it is on single-use goods that such taxes and subsidies mainly fall. Nevertheless, although the questions raised by international fiscal measures are of enormous importance, there is not a great deal that needs to be said about them at this stage of our analysis, for two reasons.

In the first place fiscal policy is only one of the means

[1] It can (or so I am informed) be shown by an extension of the mathematical analysis in Hotelling's *Edgeworth's Taxation Paradox* (*cit.*) that if all of a group of commodities are produced under perfect competition, the system of taxes which will minimize the loss of surpluses is one which will reduce the consumption of each member of the group in the same proportion. The above conclusions are special cases of this general proposition. For if any member of the group has a completely inelastic demand or supply, a tax on that member will reduce its consumption by zero; the ideal tax on other commodities should therefore be zero, for a positive tax will reduce their consumption, that is to say, it will reduce it more than the consumption of the first commodity is being reduced.

available for carrying international policy into effect, direct agreements between governments, and international monetary and exchange policy, have to be considered alongside, so that to discuss fiscal policy in isolation is not usually satisfactory In the second place taxes on imports can rarely be considered apart from the fiscal policy of which they form a part, except when they are of the Victorian "revenue only" type Even though an import duty may initially have the limited aim of protecting only a small range of home industry (e g , to allow of the development of an "infant industry", or of one complementary with established industries), it is notoriously difficult for governments to resist the extension of protection In fact, import duties tend to be considered as part of a "system", as indeed the word "tariff" implies

British experience in the inter-war period is a good example of the typical sequence of events [1] Starting at the beginning of the period with a limited range of "key industry" and "McKenna" duties, which owed their origin to war experience, protection spread in various directions in the middle 'twenties (under Mr Churchill), and finally became a "system" in 1931 (under Mr Chamberlain) The discussion of tariff "systems" belongs to the field of the combined effects of public finance on the economy, rather than to the analysis of particular ways of raising revenue with which we are concerned in this part of our investigations

Outlay taxes on internationally traded goods fall on the margins of consumption and production, and of saving, in an exactly analogous manner to internal taxes of the same type We have as usual to take account of the degree of monopoly in the industries concerned, and to be on the look-out for factor or product relation The operation of an international tax, however, differs in some respects from that of an internal duty

In the first place some of the productional margins which are affected by the tax will be abroad, beyond the range of

[1] For a fuller account of the gradual adoption of protection in Britain cf U K Hicks, *The Finance of British Government*, pp 240ff

the control of the country imposing the tax, and of whatever benefits its public finance policy may bring about In one sense this implies that only a part of the loss of surplus consequent on the tax falls on nationals, but, on the other hand, especially in the long period, the taxing country may injure itself by damaging its customers abroad

A second difference is concerned with the effect of the tax on marketing conditions in the taxed industry There is always a certain danger that an outlay tax may reduce the number of producers in the taxed industry to a point at which their control of the market becomes monopolistic through the elimination of weak rivals, as a result consumers may find output restricted and prices raised against them by more than the tax Damage to consumers in this manner is probably more likely in respect of a protective duty, because instead of the high cost home producers being eliminated it is the low cost foreign producers who are cut off from the market, while the high cost home producers are protected

A third difference between international and internal taxes is concerned with their effects on the terms of trade and the balance of payments This again is a question whose main reference is to Part III, a deliberate policy of affecting the foreign balance usually calls for a tariff system, supported by direct action Nevertheless, a single import duty on an article which forms an important import may have effects on the foreign balance which are far from negligible

What the effects of any particular tax or subsidy will be on the terms of trade and on the balance of payments depends on the relative cost and demand conditions in the countries concerned Generally speaking, a tax on imports improves the terms of trade and strengthens the balance of payments, a tax on exports improves the terms of trade while a subsidy on exports will tend to weaken them, but may strengthen the balance of payments All of these effects may be neutralized or reversed if the taxes or subsidies provoke retaliation

The classical British case for free trade was tacitly founded on two arguments, first on the universal truth that under

conditions of perfect competition and full employment any international tax or subsidy would hinder the optimum allocation of resources between nations and regions, and secondly, on the purely local argument that as British import duties must inevitably mainly fall on goods of working class consumption, or on raw materials (since these between them accounted for most of our imports), import duties tended to increase the cost of British manufacture relatively to that of other countries, either by increasing the cost of raw materials or by forcing producers to raise wages

The Victorians were therefore careful to impose only "revenue" import duties, that is to say, the duties were either confined to goods which could not be produced at home (e g, tobacco), or if the home production of a commodity which it was desired to tax was considerable, an excise equivalent to the import duty was imposed on the home output, so that it received no benefit from the import duty Import duties of the first type would have no effect on producers' surplus at home, if home demand was inelastic its effect on consumers' surplus would also be negligible (if the foreigner's supply was inelastic the effect on home surpluses would be negligible, whatever the shape of the demand curve) Import duties accompanied by excises would have no more, and perhaps less, effect on surpluses than a purely internal tax, imposed in similar cost and demand conditions

In the world of to-day the conditions under which free trade would automatically secure an optimum distribution of resources no longer fully hold, it is often only too apparent that the international allocation of resources has already been distorted by monopoly elements or political action On the other hand, under modern conditions, there are several ways in which a country can benefit itself by imposing import duties,[1] above all when there is unemployment at home, and not all of these will necessarily lead to a contraction of world incomes It is possible for instance that some import duties may be a

[1] For a discussion of the use of import duties in developing countries see below p 302

necessary part of a national policy whose net effect on the foreign suppliers of the taxed goods is not adverse, because of the effect of the increased activity in the taxing country on its demand for other imports

While considerations such as these have led the present generation of economists to look with greater tolerance on protective duties than their fathers did, it remains true that international taxes are a dangerous method of pursuing the ends of economic policy The risk of retaliation, which would wipe out the benefits of the tax, and eventually leave the world poorer, is very great On balance international taxes tend to cut down world trade and production, if it is possible to restore national equilibrium by methods which expand international demand rather than contract it, it is clearly better to do so

CHAPTER XI

OUTLAY TAXES ON CAPITAL GOODS

§ 1 **Local Rates and Real Estate Taxes** The taxes which we now have to consider are of very ancient origin, in many countries they have been forerunners of a general income tax (as we have seen to be the case in Britain) They have normally been connected in some way with land and buildings—"real estate"—William III's Land Tax and the eighteenth-century hearth and window taxes are typical examples Real estate is still the easiest type of property to tax, relatively simple both in respect of the assessment and of the collection of revenue In modern times the increase of other forms of consumers' capital goods has made it possible to extend the scope of these partial taxes, but real estate taxes remain the most important type A tax of this nature may be levied either on the enjoyment of a particular form of property or on its use in production, either in general or for certain purposes (Taxes of this latter type are often known abroad as franchise duties or severance taxes) In either case (as will be apparent from our discussion in Chapter IX) the formal incidence is on the consumer—of the direct satisfactions afforded by the property, or of the goods produced with its help

More rarely partial taxes are levied on income (profits) derived from a particular type of property (as from gold and diamond mines in South Africa) Partial income taxes of this sort are naturally classed by administrators as direct, and they would not normally be among the taxes whose revenue goes to make up the difference between the "factor cost" and "market price" calculations of the national income, nevertheless their effective incidence is that of outlay taxes rather than of income taxes

On the other hand there is a British tax which is (or used to be) referred to as "the property tax", which is a true income tax This is Schedule A of the general income tax (levied on income from ownership of land and buildings) This schedule is needed to complete the generality of income tax If income, derived either in terms of money or of satisfaction, from this particular source were free of tax, it would constitute a subsidy to one particular method of acquiring income In the United States, where the income which home owners derive from their own houses is free of tax, a limited subsidy of this type is, in fact, available, and can be used by the wealthy for reducing the rigours of progressive taxation

Taxes on real estate are very commonly used as a source of revenue for local governments This is partly due to historical accident, in the days of primitive transport, towns and villages had to rely on their own resources for the provision of collective services, local property was then the obvious tax base, and was moreover, at that stage of development, a reasonable indication of ability to pay These conditions have now passed away, but the independent nature of such a localized tax base still makes real estate taxes a convenient source of local revenue, this is a point which we shall have to discuss more fully at a later stage [1]

From the point of view of incidence the use of these taxes for local purposes adds an additional complication Local taxes are inevitably levied at different rates in different districts, so that the possibility of evasion of high rates of tax by removal to a lower taxed area is always open to the taxpayer, this tends to enhance already existing disparities of local tax levels, and may have far-reaching effects on the distribution of productive resources

The general operation of taxes on durable-use goods is similar to that of other partial taxes A rise in tax causes an increase in market price, this leads to a fall in demand, and later to a readjustment of supply, and a tendency for factors to transfer to other occupations, conversely a fall in tax

[1] Cf Chapter XV, Sections 5 and 6

causes an expansion of demand and a consequent attraction of factors Owing, however, to the durable nature of the property, and partly also to the length of time required for the production of new units of output, the effect of a tax change on supply takes some little time to become evident A tax-induced change in the annual rate of construction or demolition of buildings, for instance, makes but a small difference to the total buildings in existence, consequently, in analysing the early stages of the operational process, the supply may be taken for all intents and purposes as fixed

When a tax is imposed on a single-use good, the main adjustment is on income account, indirectly the capital value of the equipment used in the production of the taxed good will fall as a result of the tax, but how great the effect will be depends on a number of factors—apart from questions of demand—on the life of the plant, for instance, and on the extent to which it is specific to the taxed line of production Per £ of revenue collected, the effect on the capital values of any particular type of capital instrument will probably not be very large

The case is very different when the tax is imposed directly on the capital goods themselves, their values will be immediately affected on investment account, and this change will influence production independently of the influence due to the fall in incomes derived from the use of the taxed equipment If the taxed goods are very durable, and the tax is expected to continue indefinitely, the discounted effect of the change may make a large difference to present capital values On the other hand if the taxed goods last only a few years, and particularly if there is no organized second-hand market, the effect on capital values may be negligible, and the operation of the tax will approximate to that of a tax on single-use goods Wireless "licences" provide an illustration of this latter situation, real estate taxes are typical of the other extreme

A further complication arises from the fact that instead of being consumed by their owners, goods of long life may be hired out for use by others, either in production or in

consumption (in either case from the point of the owner they are then employed in the productive process) A single piece of property of long life, such as a house, may be subject to a succession of leases during its lifetime, and alternatively it may be subject to several different kinds of leases at the same time There may be thus a large number of people whose position is directly affected by the tax change, although they may not all feel the effect simultaneously—for instance, a rise in local rates cannot be of any immediate interest to the holder of a 999 years ground lease in the early years of its currency

When property is commonly leased the tax may be assessed either on the owner or on the lessee In the short period the method of assessment makes some little difference to the effective incidence, since until leases can legally be readjusted the whole burden of readjustment to a tax change is thrown on the party on whom the tax is assessed In this connection it is sometimes necessary to distinguish between legal obligation to pay the tax and method of collection In England and Wales local rates are assessed on the occupier or tenant, but on all small houses they are paid over by the landlord, who collects the rates at the same time as he collects the rent, in Scotland on the other hand liability is divided between landlord and tenant An English landlord is thus entitled to pass on to the tenant the whole of a rise in rates as soon as it occurs, although no doubt he does not always do so, a Scottish landlord can take no action in respect of owners' rates until a new lease is arranged

The possibility that a property tax may be assessed on someone other than the owner is obviously an additional complication which may or may not be present, so that it will be convenient to discuss this part of the operation before we come to the more general analysis of property taxes In order to simplify the analysis we may confine our attention in the first instance to a tax on property used for consumption (such as the British local rate on dwellings),[1] and further we

[1] For further discussion of the British tax, cf Hicks (J R and U K), *The Incidence of Local Rates in Great Britain*

may assume for the present that the supply of houses is fixed—as it must be in any case in the short period

§ 2 **Local Rates and the Adjustment of Net Rents** At the moment of the change in tax it is clear that the tenant (or in Scotland the landlord and tenant jointly) must bear the whole of any rise in rates, equally, after a fall in rates the landlord will not be able to alter a rent contract unfavourably to the tenant during the currency of the lease, but after that point the question arises whether tenants with their small incomes and smaller reserves are in a position to force landlords to lower rents after a rise in rates, or to withstand a rise in rents when rates have fallen

It is obvious that landlords are normally in a stronger financial position than their tenants, and, further, tenants have given hostages to fortune by the fact that they are fixed in their houses They will have to incur heavy costs—in money and in convenience—if they choose to move out There are some circumstances in particular (as we shall see) in which tenants will be extremely loth to make a move, and will consequently put up with a considerable rise in gross rents (rents plus rates) before doing so The superior strength of landlords does not, however, necessarily put them in a position to exercise monopolistic pressure, there are normally few houses or sites so unique that appropriate alternatives cannot be discovered Families do not generally intend to remain indefinitely in the same house, family circumstances and incomes change as time goes on, and in fact it appears that most households move fairly frequently [1] In London it was said that on the average the whole population used to move every three years

The position becomes clear if we reflect that a rise in rates is for the ratepayer equivalent to a fall in real income Payments for house accommodation are now larger in relation to his money income than he would wish, he will want to restore

[1] Where there is a large amount of rent control in the economy so that there is a wide difference between controlled rents and potential free market rents mobility may be seriously impeded

his budgetary equilibrium as soon as opportunity offers, either by obtaining a reduction in the net rent, or by moving into smaller quarters Thus when rates have been rising, tenants taking out new leases will insist on lower (net) rents There is no reason to suppose that landlords will be able to find similar tenants who will be satisfied with the old rent, since the spending power of all tenants will have been reduced Hence landlords will have to acquiesce in a fall in rents

The rent adjustment need not necessarily take the form of a direct money concession, an equivalent effect may be obtained by an alteration in the amount or quality of the repairs and other services performed by the landlord [1] It is important to notice also that the change in tax does not affect all property equally After a rise in rates a landlord may not be able to find a similar tenant at the old rent, but he may succeed in finding a tenant with a larger income who previously lived in a bigger house Thus a rise in rates will affect large houses more than small The rents of small houses may still tend to fall, in spite of the movement of demand in their favour, because housing expenditure can also be reduced by taking in lodgers

A change in rates will also tend to affect old and new property differently Normally new houses are preferred to old, so that a change to new houses would be stimulated by a fall in rates, and *vice versa* for a rise In Britain during the inter-war period this tendency was largely offset by the fact that the new houses were cheaper to run (and easier to manage without servants), and further that they were often relatively under-valued for rating purposes[2], but in principle a fall in rates should stimulate the demand for new houses relatively to old

The extent to which the net rents of houses (or more broadly the conditions of letting) will be adjusted after a change in tax differs according to the type of district where the change takes place The adjustment of net rents which tenants as a body are able to extract from landlords as a body may be greater

[1] A change in this respect may follow immediately on the change in rates and should be counted as part of the operation of the tax

[2] Cf Hicks (J R and U K), *The Problem of Valuation for Rating*

than the rise in rates (in declining districts it is likely to be so), or it may be the same or it may be less. In expanding areas net rents may continue to rise in spite of the rise in rates. The amount of the change in rent is no criterion of the extent to which landlords are being forced to share the readjustment after a rise in rates. The only measure of this is the difference between net rents[1] as they become after the rise, and as they would have become if there had been no rise in rates. Only if there is no difference between these two can we say that the tenant has been forced to bear the whole costs of readjustment.

A declining area is one from which population will be moving, consequently at any moment there will be a number of families who value the costs of removal lightly. They have it in mind that they will move shortly in any case, and a slight provocation will tempt them to accelerate the plan, consequently, landlords will be in a weak position to refuse a reduction in rents. In an expanding area on the other hand, alternative accommodation is hard to come by, and tenants will be abnormally reluctant to leave the houses they are in. These local differences in tenants' and landlords' attitudes are intensified by the fact that the rate is a local tax, differing in amount from place to place. Declining areas tend to have high rates, and the high rates provide an incentive for people to leave, and thus hasten the decline. Expanding areas tend to have low rates, and although the cost of providing public services for new housing estates is initially heavy, it is normally compensated within a short period by the increase in rateable value.

There is thus an important local difference in the extent to which, after a rise in rates, readjustment can be forced on landlords by tenants. In declining areas a great part of it can be, in expanding areas probably very little. Thus if rates rise, in expanding areas rents will be a little lower than they would otherwise have been, but probably not very much. But in declining areas rents will be low, not only because the general prospects of the district make it unattractive, but also because high rates are continually forcing them down.

[1] Or more strictly, net letting conditions.

Another situation in which tenants will be abnormally reluctant to leave their houses in spite of a rise in rates is one in which they enjoy beneficial rents, due either to the effective operation of rent control or to the policy of local councils on their housing estates Tenants of beneficially rented houses must be prepared to bear the full cost of adjustment after a rise in rates, on the other hand they will reap the full advantage of a fall in rates, whereas in every other situation it must be expected that after a fall in rates landlords will endeavour to push up net rents—to make them higher, that is, than they would have been but for the fall in rates Thus when opportunity offers it must be expected that tenants will be required to share with landlords the higher real incomes which a fall in rates implies for them

How long the initial period will be before rents begin to be adjusted depends naturally on the type of rent contract in force, which differs considerably from one part of the country to another Probably most working class houses are let on weekly contracts, but no change is likely to be made unless the change in tax is expected to last, and in any case rents are notoriously sticky, consequently, the period of fixity should probably be interpreted in terms of months or even a year or two, rather than in terms of weeks For larger houses leases of six or seven years are common If in addition to the landlord of the house there is a ground landlord a similar process of adjustment between landlord and ground landlord will eventually take place, but in this case an interval (on the average) of twenty to forty years must elapse before the adjustment process proceeds

Property owners are affected by a change in tax, not merely in respect of the rents they can obtain, but also, and perhaps more importantly, by the adjustment of capital values[1] to the new situation A rise in rates will cause an immediate fall in

[1] In the traditional terminology the reflexion of the change in capital values in the selling price of property is described as the "capitalization" or "absorption" of the tax When a tax has been in operation for some time, without change in rates, relative capital values become completely adjusted to the tax, and in this sense, "an old tax is no tax"

the value of house property relative to other forms of investment, it is as if an additional ground rent had been imposed on the property (and *vice versa* for a fall in rates) Thus after a rise in rates, investment in houses becomes relatively unattractive until equilibrium is restored—usually by a growth in the demand for house room relatively to the supply In declining areas this point may be almost indefinitely postponed

Home owners are thus doubly penalized by a rise in rates Not only must they bear the whole cost of readjustment on income account for so long as they own the house, but the value of their property is also diminished When they come to sell the house its value will be less than it would have been otherwise because of the discounted value of additional and expected rates Once again the actual change in value may be more, or less, or exactly the same, as the present value of the future rate charge, according to the type of district Conversely home owners gain doubly from a reduction in rates—on income account as occupiers, and on capital account as owners

§ 3 **Local Rates and the Volume of Building** So far we have concentrated on the operation of the tax in the period before it becomes possible for the supply of houses to be altered, so that the values (and rents) of existing houses are affected only by the change in the tax and not by alterations in the number of houses as a result of the tax A fall in rates stimulates new building because it raises the net price people are prepared to pay for houses (to live in themselves or to let to others) Houses which before it would not have been profitable to build now become profitable For essentially the same reason, a fall in rates stimulates repairs to existing houses

As the new houses are built, they add to the supply of houses, and their competition brings rents down Thus if in the first phase there may be some tendency for landlords to benefit from a fall in rates, in the following phase (logically rather than temporarily successive, since both may proceed simultaneously)

the advantage is transferred back to tenants In the same way, part of the advantage got by home owners from a fall in rates will be lost to them when the increased pace of building diminishes the value of their property

The same process holds, *mutatis mutandis*, for a rise in rates The pace of house building will be checked, consequently the ability of tenants to transfer their increased rate liability to the landlord will be limited by the scarcity of houses Looking at the matter generally we may say that if the effect of rates on new building is small, most of the effective incidence of rates will in the end be transferred to the landlord, but if the effect on new building is large, most of the effective incidence will remain on the tenant

Consideration of reactions through new building therefore reinforces the conclusions already reached In a declining area where for other reasons the effective incidence is more likely to be shifted on to landlords, there will in any case be little new building for private profit Changes in rates can therefore have little effect on new building, and the conclusion that the effective incidence will be mainly on the landlord stands

In expanding areas, on the other hand, while there is likely to be greater stickiness in rent contracts, nevertheless changes in rates will affect the selling price of houses, and will therefore affect the profitability of new building There will in any case be some new building in such areas, but its amount may well be affected by such changes in profitability Thus on both grounds effective incidence will be on tenants

The local rate—or any similar tax on real estate—is thus from one point of view a tax on building, and a reduction in the tax will have the effect of a sort of housing subsidy If the aim of policy is to get new houses built, however, a subsidy paid only on them is much more effective and more economical of revenue than a reduction in rates (brought about, for instance, by the transfer of some rate-borne services to central funds) The greater part of a reduction in rates must go to benefit directly the tenants (or landlords) of old houses, the

stimulus to new building is confined to the opportunity given to builders of new houses to get a share in these benefits

In the first instance a housing subsidy will benefit only the builders (including the producers of building materials) and the tenants of new houses Nevertheless, since new building tends to reduce rents generally, the encouragement of new building does indirectly confer a benefit on all tenants, but if any type of building labour or materials is in short supply and not easily procurable, the effectiveness of a subsidy in getting houses built will be partly wasted in a rise in building costs This is not an argument against subsidies, but merely a warning that any measure designed to expand building may have to be supplemented by direct action to remove bottlenecks and increase elasticity of supply

No great extension of our analysis is needed when we turn from taxes on houses to taxes on industrial and business property The formal incidence of such taxes, it will be remembered, is on the consumers of the products and services provided with the help of the taxed buildings If the property is leased, in the first instance the effective incidence will be on the occupier, exactly in the same way as a tax on houses, subsequently an adjustment process will take place between landlord and tenant in an exactly analogous manner to that which we have already examined There is, however, a further relation to consider, that between the manufacturer or business-man and his customers or clients, where the building is owned by the occupier this is the main consideration in the effective incidence of rates on business property

For the producer the rates which he has to pay are an overhead In the short run they will probably be paid out of profits (at least this would be the economically correct procedure), but in the longer period rates are one of the costs that must be covered in selling price The producer has the alternatives of charging additional rates into price, or of transferring his energies elsewhere Which course he follows will depend on similar considerations to those which determine his conduct when confronted with a new tax on a single-use good,

considerations of relative elasticities of supply and demand, the degree of monopoly and the ease with which specialized factors (including his own abilities) can be transferred

If we are concerned with a tax which varies markedly in severity from place to place, there is a not inconsiderable danger that producers will seek to evade high rates by removal to another area, or more likely by establishing new factories only in low rate areas From the point of view of local finance the shutting down of a factory is more serious than the gradual drifting away of domestic ratepayers from high-rated areas The producer is more likely to be influenced by purely economic motives, and among those he does not count the cost to the community of the unemployment which he leaves behind him This danger was one of the main reasons which led to the derating of "industrial hereditaments" (i e , those buildings where a manufacturing process was performed) as to 75 per cent of their liability to rates in 1929 By this measure the importance of rates as an industrial overhead seems to have been reduced below the *minimum sensible*, at least for the time being, in spite of the fact that rate poundages have since risen very considerably in towns where factory property formed a large proportion of rateable value In such places a heavy additional burden was thrown on the overheads of other business (especially of shops) which remained fully rated, so that the generalized benefits of derating were partly offset by a loss to particular local interests

§ 4 Other Property Taxes In so far as franchise taxes are imposed on the letting value of property their operation is exactly similar to that of the taxes on real estate we have already considered, except for the fact that the main effects are localized in the particular part of the economic field concerned Demand, and hence production in that line, will be restricted in the event of a new tax, and stimulated in the event of a tax reduction, analogously to a change of tax on a single-use good There is, however, the possibility that liability to franchise taxes may be based on an estimate of

profits (deduced from past receipts), in this case the operation of the tax will approximate to that of a selective income tax on property, if the tax is not expected to be permanent at current rates there will be some attempt to adjust the realization of profits over time, so as to minimize the total tax that will have to be paid

The incidence of taxes on less durable goods (such as the "licence" duties on motor vehicles) differs mainly from the corresponding taxes on real estate by the smaller proportional effect of changes in capital values Thus the operation of the tax on private pleasure cars corresponds to the domestic rate on home owners, there is an analogous tendency for a rise in tax to cause a shift in demand from bigger or better cars to smaller cars, and for a reduction in tax to stimulate the demand for expensive cars The precise formula according to which liability is assessed is of very great importance in this respect, since manufacturers will naturally adjust their designs so as to maximize the net attractiveness (satisfaction in use less tax) to prospective purchasers Similarly, the operation of "licence" duties on buses and taxis follows that of domestic rates on leased property—the lease being considered as a series of short contracts rather than a single durable one, and finally, the operation of licences on such vehicles as lorries and delivery vans is analogous to that of buildings owned and used in production, but in every case without much importance in respect of capital effect

Before we leave the incidence of taxes imposed directly on capital goods themselves there is one further point to be noticed As we have seen, the British local rate is assessed in relation to rents, that is to say it is based on *annual* values, in most other countries the corresponding tax is based on the selling price of the property, that is on the *capital* value There is a fundamental distinction of principle here, although in practice the difference it makes either to valuation or to incidence is often not very great Annual values take the situation as it is, and have no thought for the values of tomorrow, selling prices, however, take into account not merely the present rent the

property commands but also the market's expectation of future rents which can be foreseen from the expected development of the property or the neighbourhood, allowing of course for the probability that these expectations may not be realized for some time and so must be discounted accordingly

Where properties are not normally rented it is obviously inevitable that the tax base should be capital and not annual value In a developing country this is a positive advantage since the expectation of increasing value is probably considerable and should by all means be included in the tax Generally speaking, however, capital values are more difficult to assess correctly than annual values, property which has recently been sold may easily not be a good guide for the true present value of other properties in the neighbourhood For this reason an element of judgment enters into the valuation which is absent from annual valuation, at least where there is no widespread rent control, and this leads to uncertainty and loss of objectiveness

A variant of the capital value base is what is known as the taxation of site values This method seeks to base the tax on the capital value of the site alone, either ignoring the buildings or other improvements which have been made upon it, or attempting to value them separately and tax them at a lower rate Two possible purposes may be sought by site value taxation In the first place since liability to tax will not be affected by the character of any building which is put upon it, there is no fiscal deterrent to putting up the type of building which holds out the biggest prospect of return, this may or may not be a larger building than if the tax had included the building, but there is some *a priori* likelihood that it will be better or larger than if it had been subject to tax also Secondly, site value taxation (supposing the valuation is carried out correctly) will secure for the revenue the increment of value of the site due to the expansion of the neighbourhood, an increment which is, so far as the individual property holder is concerned, "unearned" Site value taxation is thus based on the theory of "economic rent" or surplus, which accrues to the

owner of a factor (such as land) of which the total supply is fixed, as the demand expands for the products which the factor in question helps to produce The virtue of such a tax is that it has no adverse effect on productivity, so long as it is really assessed on true economic surplus

This increment of value will also be secured by an efficient valuation based on the full capital value of site and building, but since the results of the owner's enterprise are then definitely included in the tax it will not be without productional effects

The difficulty about site value taxation lies on the side of the actual valuation Only vacant sites are sold alone and even then improvements are often incorporated in them, in all other cases it is the unit of site and improvement which comes on the market and consequently it is only in respect of this that market evidence is available Once a building has been erected on a site there is no objective means of establishing the respective contribution of site and building to the value of the whole, even if they can be logically disentangled, which is by no means certain There is thus a chronic shortage of market evidence on which site valuations can be based This implies an element of arbitrariness in the valuation, over and above that which as we have seen is encountered in full capital valuations In respect of these last the valuer's task is merely to interpret the judgment of the market, but when he is assessing the value of a built-up site a much greater effort of the imagination is required, and appeal from his valuation is virtually impossible

In site valuation not only must the valuer foresee the future development but he must postulate when it is likely to take place, an error in this can make a substantial difference to the present discounted value of the site If the error is one of over-optimism on the part of the valuer, much hardship may be inflicted on the taxpayer who is effectively charged on income which he has no means of earning In practice it seems that those countries which have been most contented with site valuation taxation (New Zealand and Denmark) have tended to set their valuations with a very generous discount,

but by this means of course the revenue potential may be seriously reduced, over and above the reduction due to the narrowing of the tax base by the omission of the improvements

In view of the difficulties of site value taxation and of their pressing needs for revenue, developing countries will probably be well advised to content themselves with taxing expected development values within full capital valuations If it is desired to encourage particular types of development this can be arranged through reduced rates of rebates [1]

If it is attempted to change over to a site value tax in a country which is already developed and where the population is more or less stationary, the costs and difficulties of valuation on the one side, and the windfall gains which will accrue to the owners of large and expensive buildings on the other, will probably be found to outweigh the productional advantages which would accrue, especially as these would only fully accrue if the tax is assessed on true economic rent alone If the new tax were in substitution for a tax on the value of the complete unit, whether annual or capital, there would also be a substantial loss of revenue to be faced, which it would be difficult to make up in such a country through the inclusion of expected development values As Edgeworth said at the beginning of the present century, when the Liberal tax on "unearned increment" was the centre of political controversy, the basic objection to such a tax in Britain is that "there is no money in it" [2]

Taxes may be assessed on the whole value of the site, but the basic object of site valuation is to provide a means of taxing the "economic rent" or surplus which accrues to the owner of a factor (such as land) of which the total supply is fixed, as the demand expands for the products which the factor in question helps to produce As Mill pointed out in the 1840's this is a very "proper subject of differential taxation" [3] If it can be taxed, the tax has a double virtue First, it secures for

[1] Cf J R & U K Hicks, *Taxation and Finance in Jamaica*
[2] Cf Edgeworth, *Collected Papers*, Vol II, Sections U and V
[3] Cf p 130

the community the increase in the value of the property which is due to the expansion of the local community and not to the exertions of the owner, and secondly, since the increment of value is "unearned" by the owner, the tax can have no restrictive effect on enterprise In order to obtain this result correctly it is necessary to estimate the value of the site in its virgin or "unimproved" state (as originally provided by nature), and to tax only the increment in value due to community action

In new countries where it has been possible to obtain a selling value basis for undeveloped sites, and where development has been taking place rapidly, considerable use has been made of taxes of this nature

CHAPTER XII

GENERAL TAXES ON NET INCOME AND PROFITS

§ 1 The Welfare Effects of Income and Outlay Taxes Compared For outlay taxes the rates of tax to be paid do not differ between one person and another, individual liability differs only because of differences in the amounts or qualities of taxed goods which are purchased For income and capital taxes, in contrast, each taxpayer's liability has to be separately calculated, according to his wealth and circumstances

In respect of a personal income tax two preliminary questions have to be settled before this calculation can be made First, receipts on income account must be separated from receipts on capital account (since a true income tax seeks to tax only the former)[1], secondly, a decision has to be reached as to the costs which are to be allowed to the individual in reducing his gross receipts to the net income which is the basis of his liability In British income tax a further stage is also required, consisting of the reduction of net (or "actual") income to "taxable" income by the deduction of a number of reliefs or allowances, which are designed to take account of the taxpayer's personal circumstances, we shall have to discuss these in detail at a later stage

The task of distinguishing the income stream from casual capital receipts is not usually a difficult one, there are, however,

[1] Probably from the economic point of view the best definition of income is the sum which the owner can consume in any period without diminishing his total wealth (capital), cf J R Hicks, *Value and Capital*, p 172 In many circumstances this would include some capital gains As we shall see later (p 216 below) there are great administrative and technical difficulties in working an effective and equitable general tax on capital gains, with adequate compensation for losses On the other hand the effective taxation of total capital (including gains made during lifetime) by means of inheritance taxes is both simple and equitable

always a few borderline cases which may give trouble—for instance, where income is normally derived from a series of capital transactions (as the income of the stock-jobber) In such a case as this it is perfectly correct to tax capital gains as income Difficulties of another type arise because it is sometimes within the power of taxpayers to substitute capital gains for income (e g , by arranging to receive bonus capital distributions in lieu of dividends, from firms in which they have a controlling interest) Such capital gains are truly income and should be subject to income tax, but it is not always easy to detect them, and much of the evasion of surtax which takes place is probably of this nature This type of tax evasion cannot suitably be guarded against by the extension of income tax to cover capital gains in general[1], but means of taxing particular methods of substituting capital gains for income can usually be found, within the framework of the income tax, by a diligent revenue department

The process of determining the costs to be allowed in reducing gross income to net gives rise to more general difficulties In practice "personal" costs are determined by revenue authorities in a quite conventional manner, in Britain they include a limited allowance for occupational and living costs (such as tools supplied by the workman, life insurance premiums and mortgage interest on a dwelling house), but they exclude the cost of acquiring a professional position The costs to be allowed to a business firm for the non-personal section of British income tax are also settled in a conventional manner, those acceptable to the revenue authorities are not necessarily those which an accountant or an economist would consider appropriate, and this may make a given rate of tax more onerous than it need be This is an important point to which we shall have to return later

The most serious technical difficulties in assessing income tax probably arise in distinguishing between costs, profits and personal income in the case of the small firm The indifferent accounting methods often used by such businesses

[1] Cf pp 216ff

cause their owners in many countries to escape a not inconsiderable part of their tax liability The inequity caused by this sort of evasion has been one of the main reasons for the unpopularity of the income tax when first introduced, both in Britain and in other countries The difficulty has now been largely overcome, in Britain at least, partly by the expansion in the size of the typical firm and the decay of family ownership, partly by improvements in the technique of business accounting In advanced industrial countries at least, income taxes can now be collected with a high degree of interpersonal equity even if from the economic point of view the conventions used by revenue authorities still leave something to be desired

Income taxes are inevitably closely linked with capital taxes, not merely because capital receipts are sometimes hard to distinguish from income, but because the two types of taxes are similarly based on the whole body of the individual's wealth—in the one case on its annual value, in the other on its capital value In practice the connection between the two types of taxes is very close indeed, since a tax which is assessed on income may, in fact, be paid out of capital, and *vice versa* Thus a temporary high income tax in war-time can be met without a proportionate reduction in consumption by selling assets[1], *mutatis mutandis* a capital tax imposed year after year will tend to be paid out of income Nevertheless, even if the same amount of revenue were to be extracted annually from each taxpayer, the effective incidence of a tax assessed on capital would probably differ to a not unimportant degree from that of an income tax assessed in a more normal manner Thus we have to take account not merely of how the tax is paid but also of how it is assessed

In analysing the operation of general taxes on income and capital we must continue to follow the "one thing at a time" (partial) method, in the sense that we are still not concerned

[1] This circumstance has sometimes led to the demand for a capital levy in war-time We shall see later (cf Chapter XIII, Section 2) that it would be ineffective for the purpose of controlling consumption and prices, and might even have the opposite result, depending on the extent to which levy payers could borrow

with the effects of the disbursement of revenue We have seen that the expenditure out of the revenue from an individual tax can only be isolated for separate discussion in the case of an earmarked tax, so that the whole question of the allocation of revenue must await the general discussion of public finance in the economy Nevertheless, our analysis must now become general in the sense that we can no longer confine our attention to changes in particular markets, but must discuss the effects of taxation on the general phenomena of consumption and investment, the factors which determine the size of the national income

The classical (or rather Victorian) case in favour of income taxes as compared with outlay taxes (see p 147) implicitly assumed that when the taxpayer is confronted with the choice of paying a certain revenue by a particular partial outlay tax or by a general income tax, his initial liability in both directions is zero In these conditions it is right to assume that he would prefer an income tax In the first place by this alternative his distribution of outlay will not be disturbed Secondly, since the rate of income tax[1] to bring in the same revenue will almost certainly be lower than the rate of the outlay tax, it will have less effect upon him It is unlikely indeed that he will be conscious of any shift in his relative preference for work and leisure as a result of paying the income tax, and so he would sustain no loss of surplus

The conclusion that an income tax entails no loss of surplus rests fundamentally on a neglect of the costs of acquiring an income—the wear and tear to the individual, and the subjective disutility of work—so that it is only strictly true of a tax on income from work so long as the rates of tax are moderate, and more particularly when the taxpayer has no opportunity of varying his income by varying his effort In this case there are no substitution effects and the income tax approximates to a "lump sum" tax which we have seen to be "ideal" from the productional point of view Nevertheless, in many circumstances it is true that there will be a gain in satisfaction as a

[1] On account of its "importance", see p 148

result of a change from outlay taxes to income taxes, the main advantages, however, must be sought in the field of distribution

By far the greater part of the revenue from outlay taxes is derived from the lower income groups (merely on account of their larger numbers), the revenue from income taxes on the other hand mainly comes from the upper income groups, because of their larger incomes Thus a switch over from outlay to income taxes would make the tax structure substantially less regressive, and would improve the relation of taxation to ability to pay It also follows from this income distribution of revenue that outlay taxes tend to be paid at the expense of consumption, income taxes partly at least at the expense of saving Thus a switch over to income taxes would tend to stimulate spending in the economy, by enabling the lower income groups to spend more, while not seriously preventing the higher income groups from spending as much as before The opposite of this is of course that high and progressive income taxes tend to check saving, both by seriously curtailing the incomes of large savers and by taxing the large spenders less heavily In order to appreciate the dangers in each direction—and also in order to judge how far they might be mitigated by internal improvements in the tax—it will be desirable to examine the rather peculiar construction of the traditional British income tax

§ 2 **The Structure of British Income Tax** Since the introduction of supertax in 1910 British income tax has been made up of three distinct elements (i) a simple proportional tax falling universally on personal incomes above a certain low exemption limit, and assessed at a single "standard" rate[1], (ii) a tax on the undistributed profits of all firms, assessed at the same "standard" rate, and (iii) a progressive surtax on personal incomes above £2,000, assessed at rates that increase fairly rapidly on successive increments of income Administratively British income tax is thus effectively three separate

[1] Apart from complications concerned with "reduced rates", and with "reliefs" or "allowances", see pp 185, 186, 188ff

taxes, but economically it consists of two taxes only, a progressive personal income tax, with a low exemption limit, and a proportional tax on business The first two of the three administrative elements are the direct descendants of the original income tax, the third is the successor to the supertax of the Liberal government of 1910, when, however, the exemption limit was £5,000

Liability to the two personal elements of the tax for those coming within the surtax range is determined at one operation on the basis of a return of total income made by the taxpayer soon after the beginning of each financial year, but the collection of income tax and surtax takes place in two operations,[1] surtax being due a year in retard of income tax On the other hand a large part of the personal and impersonal revenue from income tax (as distinct from surtax) is collected together by a very simple device The total profits of firms are taxed at the standard rate, and dividends are then distributed to shareholders net of this amount of tax

This "deduction at source" constitutes a first approximation to discharge of liability to the personal tax, each individual's position is subsequently adjusted, with reference to his return of income and the reliefs to which he is entitled, by means of an additional payment or a refund, according as his correct rate of tax is below or above the standard rate This method of collection is an important safeguard against evasion through the taxpayer failing to return the whole of his income from property, if the standard rate is fairly high it also follows that a large part of the revenue is collected in this painless manner with a very brief time lag

British income tax has always attempted to take account of the taxpayer's ability to pay, not merely in respect of his receipts, but of his needs also Some small allowances were already a feature of Pitt's income tax, and the necessity of making a return of total income in order to claim them was cunningly used as a method of reconciling the taxpayer to disclosing his

[1] Three if the taxpayer is also taxed currently under P A Y E , see below pp 189ff

total receipts, a process which experience has shown to be a *sine qua non* of an effective and equitable income tax[1] Since the beginning of the inter-war period fixed sums have been given by way of reliefs in respect of children and other dependants, in addition to a "personal" allowance for the taxpayer and his wife Further, a percentage allowance, up to a certain maximum amount, is given on income from work, thus constituting a discrimination against rentiers, this form of allowance has also been extended as an "age relief" to old-age pensioners in the lower income tax groups

As a result of these reliefs, the tax is made progressive with needs as well as with income, its relation to ability to pay is also improved in two other respects In the first place, for most taxpayers, the effective exemption limit is raised considerably above the nominal limit Thus in 1953–54 with a statutory exemption limit of £125, a married couple with three children were virtually exempt from tax if their income did not exceed £600, in 1938 this point was reached at £500 but in pre-war pounds a much higher exemption limit was implied In the second place a general element of progression is imparted into the tax, even in the range in which there is no difference in nominal rates The effect of the reliefs on the lower ranges of incomes is thus very important, but as income increases they gradually sink into insignificance

The progression of the personal income tax is, however, mainly secured by the device of charging successively higher rates on successive increments of income (this device is now usually adopted for progressive taxes) In the "income tax" range (below the surtax exemption limit), there have traditionally been two such steps, known respectively as the "reduced rate" and the "standard rate" (A second reduced rate was added in the second Budget of 1945 and more recently a third) The progression of the surtax range is now achieved by means of eleven steps

When these stepped or marginal rates of tax are averaged over the whole of the taxpayer's income the progression of

[1] Cf p 124

his tax liability proceeds in an almost smooth curve as his income expands The position is illustrated in Chart II where the curves A, A′, B and B′ represent the marginal and average (or effective) rates of tax in 1953–54 respectively for a single person with all investment income and for a married couple with three dependent children For comparative purposes the A′ curve for 1938 is also included

Since the marginal curves rise throughout their length, the average curves necessarily lie below them, but as income increases the curves approach asymptotically—since there is a definite limit (100 per cent) above which the marginal curve cannot rise Even when this point is near to being reached (as it has been since 1941) it is still possible to make the tax more progressive by introducing the maximum rate at a lower income level

§ 3 The Effect of High Tax Rates on Incentive and Enterprise. It is not possible to say in general whether a taxpayer will work harder or less hard as a result of a given change in tax rates We can, however, postulate that where a change affects marginal earnings more than average earnings his reaction is likely to be stronger because the effect is more direct and immediate A large gap between marginal and average rates of tax tends to be disincentive because marginal effort is taxed relatively highly The difference between marginal and average rates of income tax at different points on the income scale thus assumes considerable importance It will be seen that the gap is especially large first, where liability to income tax begins, and secondly where liability to surtax begins The first of these points is clearly the more important from the point of view of incentive, but here the situation has been considerably improved in recent years by the multiplication of "reduced rates", keeping the marginal and average curves closer together than they used to be

In respect of relative changes in marginal and average rates, due to alterations in the structure of the tax, the form in which the reliefs are given is important The personal and

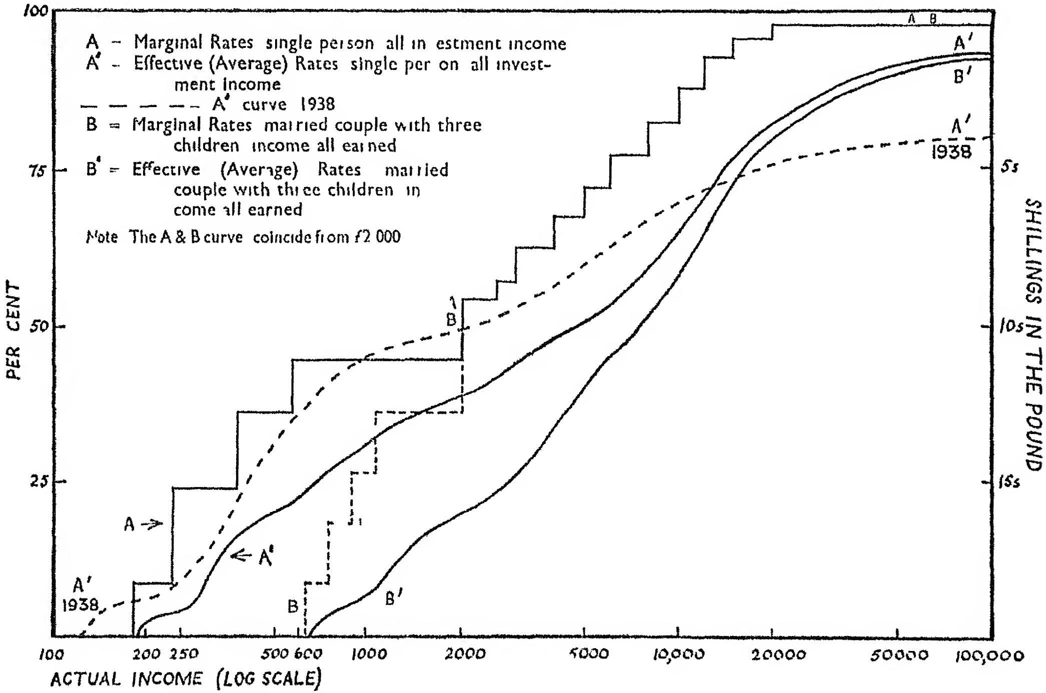

CHART 2 THE STRUCTURE OF BRITISH INCOME TAX 1953–54

dependants' rebates, being flat sums, impinge only on average rates, the earned income and age reliefs on the other hand, being percentages, affect marginal rates and are equivalent to a straight reduction in the rate of tax, which is especially marked at the lower range of liability These latter reliefs thus serve a double purpose in addition to the distributional aim of discriminating against investment income, a rise in the reliefs is likely to be definitely incentive Both these aims would be better served if the earned income relief were continued into the surtax range, as things are now it is the small and not the large property owner who is discriminated against—until of course it comes to death duties

As compared with the pre-war situation British income tax has substantially altered in character In the 1930's, with only 3 8 mn taxpayers it was essentially a middle and upper income impost, while only the wealthy came within the surtax range With the first effective war budget the exemption limit was lowered and the reliefs reduced, by this means income tax became a mass tax to which large numbers of weekly wage earners were liable, while with the fall in the value of money large numbers of middle incomes came within the surtax range In spite of reductions from war rates, in the early 1950's over 16 mn were found liable to tax, while many more "marginal" cases were provisionally assessed This change in the character of the tax was quite deliberate, it was a means of "forced saving" aimed to prevent the recipients of bulging war incomes from bidding up prices, and to set resources free for the war effort

After the war inflationary pressure still continued, but the disincentive effect of income tax on weekly wage earners, which had barely counted in war conditions, now became a serious matter The process was therefore reversed exemption limits were raised and all the reliefs have been repeatedly increased At two ninths the earned income and age reliefs stand at a higher rate than in any previous period The combined effect of the reliefs has thus come to assume a new importance This is enhanced by the P A Y E system

by which since 1943 tax has been collected from all wage and salary earners In order to appreciate the significance of this we must examine briefly the principles under which P A Y E operates

A system of "current with-holding" (to use an American phrase) became a necessity with the inclusion of weekly wage earners in the tax, since they could not be expected to carry the necessary cash balances for half-yearly or even quarterly payment For administrative convenience the system was extended to salary earners, although for the upper ranges of these tax withheld would probably only represent a payment on account of total liability P A Y E is based on current earnings, so that tax payments proceed as nearly as possible in step with changes in the national money income, and a good stabilizing effect is thus obtained Liability is averaged every pay period over the whole financial year to that point Thus the basis is annual and not merely pay period income, this implies that incomes which fluctuate within the year pay no more tax than the same income received regularly, an important point for piece workers It also implies that at the close of every pay period the taxpayer is brought into equilibrium with the revenue authorities, in all ordinary circumstances when the end of the financial year arrives he will owe the revenue nothing and be owed nothing The system is thus equitable in a very high degree

P A Y E is, however, disincentive in several respects The crux of the matter is the way in which the personal (dependants') reliefs are treated they are assumed to accrue regularly through the year at the rate of one fifty-second per week Thus in any week when earnings fall below average there is a possibility that the taxpayer will not have received the full reliefs to which he is entitled They will then be set against accrued tax liability, in a sense they are treated as a "loss" to be carried forward, if need be to the end of the financial year The combined effect of the adjustment to a lower average rate when income falls and of the accruing reliefs is to provide a species of "holiday with pay" for the

absentee If work ceases completely during the financial year he may qualify for substantial repayments, lasting over many weeks This result has much to recommend it from the points of view of equity and stability of effective demand, but it clearly carries with it serious disincentive possibilities On the other hand, in any week in which work exceeds the average, additional tax will immediately be charged, thus P A Y E is in danger of being disincentive whenever earnings fluctuate considerably

In addition to this drawback the administration of P A Y E is far from simple The weekly accrual of reliefs necessitates a separate "table" for each week in the year, while the different combinations of reliefs require the calculation of each taxpayer's liability according to a particular "code" Since the system began the Inland Revenue has taken the opportunity of "coding in" also on the one hand other costs which the taxpayer may be entitled to deduct (such as mortgage interest or insurance premia), and on the other certain items of property income which are frequently encountered in the lower income groups (such as war loan interest and imputed income from an owned and occupied house) In process of time more than 170 different codes have been delineated The task of manipulating codes and tables, so as to calculate weekly tax liability, falls on employers, a social cost which is by no means negligible Moreover, such is the complication of recalculating codes and tables after a change in tax that the change can only be made effective after a lag of at least three months Thus the usefulness of current with-holding as a stability measure is partly sacrificed to administrative convenience

In view both of its disincentive effect and of its complications there is an obvious *a priori* case for the reform of P A Y E Whatever change might be made, however, there are two features of the system which it would be a pity to sacrifice the annual basis of liability and the maintenance of a reasonably close equilibrium between the taxpayer and the revenue authorities Even within these constraints several avenues of reform are conceivable One method would be to use a

simpler system, after the manner of that in operation in the U.S.A., where family reliefs are standardized as a series of flat ($500) sums, and tax is deducted weekly according to the weekly average of anticipated annual income. This, it is claimed, has no disincentive effects, and is apparently acceptably equitable, notwithstanding that the financial year normally ends with substantial repayment of overwithheld tax.

An alternative which would be simple to administer and which would wholly eliminate the disincentive effect of the gap between marginal and average rates would be to charge the first £*x* of income (*x* being of the order of £500) at a flat percentage rate; reliefs could be given as percentage deductions which would be more equitable than the present system. A very neat solution through such a "simple tax" could be obtained if it proved possible to combine with the income tax, on the one hand contributions to social insurance, and on the other the social insurance benefits such as family allowances which are at present given twice: as positive social security payments and as negative income tax rebates. This amalgamation would lead to substantial administrative saving. Moreover, if the contributions to social insurance were transmuted into percentages from the present flat sums the sting of the loss of progression at the lower end of the income tax scale through the abolition of the reduced rates would be largely removed. Since, however, many workers regard the traditional method of social security contribution not as a tax but as an insurance premium, entitling the contributor to benefit as of right and not of subsidy, it would not be easy to get agreement for this solution.

Strong as the *a priori* case is for the reform of P.A.Y.E., there are arguments on the other side also. It is by no means certain how far the potential disincentive effects are in normal circumstances actual. It is in the nature of the case impossible to obtain statistical verification, although well-substantiated casual instances have never been lacking. There is no doubt that the willingness to work was at its lowest immediately after the war: war weariness, the abundance of

money in relation to the goods available in the shops and the negligible chance of being fired for absenteeism, conspired with P A Y E to create an inherently disincentive situation In more normal times the opportunities open to most wage and salary earners to vary their income by varying their effort are not very extensive

Moreover, the seeming complications of the coding system have in fact been turned by the Inland Revenue into a great administrative simplification Once the correct code has been identified (and it is in almost every case in the taxpayer's interest to see that this is done correctly), no return of income need be obtained from the vast majority of taxpayers Even the "simple" American system does require every taxpayer to file returns every year Further, mechanical ingenuity soon supplied firms with P A Y E machines which can be operated by unskilled clerical labour Thus the arguments for the reform of P A Y E are on the whole not so pressing as they were a few years ago This should not blind us to the real defects of the system, more especially as it applies to earners above the weekly wage level, the assessment of part of whose incomes by P A Y E makes it almost impossible for the taxpayer to estimate his outstanding liability

Although the lower income ranges are probably particularly sensitive to the *form* of income tax, in the middle and upper ranges high rates of tax may be disincentive whether they impinge on marginal or on average rates The result is more likely to take the form of reluctance to put forth maximum effort, or perhaps to undertake further training which would carry with it a higher salary, than of absence from or refusal of work, it is none the less damaging to the national product on that account More obviously tax rates which exceed what is considered reasonable lead to multifarious forms of legal evasion, for instance through expense accounts, not all of which can be checked by the revenue authorities without inflicting hardship on legitimate needs

Most of all high tax rates on the upper income ranges, more than any other factor, have almost put an end to net personal

savings and have sometimes provoked dis-saving, at least in the short run, but for this high death duties must also share responsibility The decline in personal savings is serious from two points of view Voluntary savings assist a programme of public investment by setting free resources which would otherwise have to be obtained by a budget surplus if inflation is to be avoided Loaned to private firms personal savings may still provide an important source of "venture" capital for expanding new enterprise This is a form of investment which cannot be financed from within the firm when it is itself young and small

Under modern conditions, however, the effect of high taxation of the rich has, in general, very little reference to the question of investment Investment takes place as a result of the decisions of boards of directors and is normally financed not by the direct application of personal savings of the wealthy but out of the accumulated reserves of firms The relevant factor to consider is consequently not the personal tax but the effect of the standard rate on undistributed profits in checking investment and enterprise This may be felt in two directions, one depending primarily on the absolute height of the tax, the other on the type of investment contemplated

In order to see the working of the first of these let us take the case of a firm which is considering the installation of new equipment costing £10,000 If the firm can borrow the necessary capital at 5 per cent, then £500 of the interest on the loan (as well as the necessary depreciation quota on the equipment) must be covered before any net advantage accrues from the investment Even if a net profit of more than £500 is regarded as likely, there is always the chance that less will be realized, in which case the investment will result in a loss, hence the expected profit must be sufficient to compensate for this chance Let us say that a most probable return of £600 would be considered satisfactory, taking account of the chance of loss This £600, however, is *net* profit, after tax has been paid If the rate of tax is 5*s* in the £, the necessary pre-tax profit for the investment to be worth while must therefore be £633 If,

however, the rate of tax is 10*s* in the £ the pre-tax profit must be £700, investments bearing a probable rate of return of 7 per cent are not too easy to find High rates of tax must stifle a number of promising industrial opportunities

Parallel reasoning can be applied to the financing of new investment out of accumulated reserves, except that instead of profit net of interest charges, the relevant calculation is the difference between the expected net profit (after tax) resulting from the new equipment and the receipts (also after tax) which could be obtained by an alternative use of the funds—for instance, in the purchase of securities It remains equally true that the addition to profits (pre-tax) which must be obtained for the investment to be worth while rises *more than proportionately* to the increase in the rate of the tax

In practice a firm is not faced with a single expected rate of profit but rather by a range of possible results, which may be pictured as ranged along a curve, similar to the normal curve of error In respect of risky, untried sorts of investment, where there is much uncertainty as to the result, some chance of a very high return but also a large chance of loss, the curve will tend to be wide and flat In respect of safe investments, where there is no pioneering element, the chance of loss will be negligible, and the most probable rate of return will be expected with a high degree of confidence, the resulting curve will be narrow and humped

The effect of an additional tax on profits on a curve of expected returns is to shift the curve bodily to the left, but without altering its shape or the chance of loss The chance of very high gains which formerly balanced the big chance of loss in the risky investment's curve is thus cut off, and the scales are consequently tipped against it, while the safe investment, being relatively unaffected, will become the more attractive The discrimination of high profits taxes against "venture capital" is serious for any country that means to keep abreast of modern developments, it is perhaps especially serious in an established industrial country, well supplied with most sorts of industrial equipment, and where consequently new enterprise

needs to be especially on the alert. This tax effect has also important cyclical relevance, in depression curves of expected returns tend to flatten out, many normally "safe" investments pass into the "risky" class.

A high rate of tax on undistributed profits is thus economically undesirable, at the best it cuts down reserves and so hinders the modernization of plant, at the worst it may be a serious brake on enterprise and invention. Yet it is not desirable to exempt undistributed profits completely from taxation, as has sometimes been suggested in the United States. The tax on undistributed profits is a completion of the personal tax, although they cannot use it in consumption, the profits are "income" belonging to the owners of the business (usually the ordinary shareholders), and should be imputed to them on any strict accounting of assets.[1] To free this income from tax would greatly increase the incentive for evasion of the personal tax, by means of bonus distributions. Further, if a zero or very low rate of tax were levied on undistributed profits, an incentive would be provided for the mere accumulation of reserves without any particular stimulus being given to real investment.

The aim of a tax on undistributed profits should thus be to put the smallest possible brake on production, and especially on the modernization of plant, which is consistent with the completion of the personal tax, while if possible creating a positive stimulus to enterprise and invention. This implies that if the standard rate of the personal tax is high, and it is desired to keep the same rate for the impersonal tax for administrative convenience, substantial rebates should be available, not merely for obsolescence and wear and tear, but also for new investment and for research. This is the more necessary in a period of rising prices, when depreciation allowances for income tax, based on the original cost of the equipment, may fall very far short of the sums required for replacement. Dating from the Income Tax Act, 1945, an ingenious method has been worked out which serves both these purposes. This

[1] Cf. p. 267.

is the system of "initial allowances" whereby a substantial part of the total depreciation allowance (at one period as much as 40 per cent) has been made available in the first year of the life of the equipment In the long run this concession constitutes not a reduction of tax liability, but merely an interest free loan from the exchequer Where a substantial programme of investment is being undertaken it results, however, in the postponement—sometimes the almost indefinite postponement —of liability to tax Changes in the rate of initial allowances have also been discovered to be an important factor governing the rate of capital formation by firms, they can thus act as a useful stabilizer, but this is a matter to which we shall have to return in Part III

§ 4 **The Emergency Taxation of Profits** Traditionally the taxation of business profits in Britain has been wholly included in income tax, in most other countries the income tax has been confined to personal incomes, while a separate company tax is imposed on incorporated business The British system has at least three definite advantages over this practice In the first place the integration of personal and impersonal taxes, and the taxation of undistributed profits at the "standard rate" makes it simple to tax property income "at source" by withholding tax at standard rate on dividends and similar payments Thus a large amount of revenue is collected quickly and without possibility of evasion For personal taxpayers this withholding is a first approximation to their eventual payment, in American terms it constitutes a "100 per cent credit" towards it Final settlement involves either a further payment by the taxpayer of the right to claim a refund, according as his correct effective rate of tax is above or below the standard rate

Secondly, it will be seen that no double taxation of the same profits occurs, thus it is easy to calculate what tax undistributed profits are really bearing and to make the desirable adjustments for depreciation and so on in a rational manner Thirdly, in principle there is no difference between the taxation

of incorporated and unincorporated firms, thus there is no hindrance to incorporation, such as is often encountered abroad For the small firm this is an important reinsurance against a number of risks There is no doubt that for all normal conditions this system of profit taxation is more efficient and more equitable than any other [1]

In times of emergency, however, it becomes necessary on grounds of stability, and perhaps also on grounds of equity, to impose further taxation on profits as an additional safeguard against either firms or their shareholders spending the proceeds when it is essential that they should be saved [2] In the war of 1914–18 this problem was dealt with by the imposition of an Excess Profits Duty levied on the difference between war and pre-war profits, or in exceptional cases, where no reliable pre-war standard was available, on the excess over a standard return on the "capital employed" in the business, measured by a valuation of the assets [3] This form of emergency taxation was adopted partly because it was widely felt that very high profits were being made out of the war at other people's expense This was indeed the case, but it was largely the result of the low level of pre-war taxes (there is a limit of tolerance in the speed with which taxes can be raised) and of the absence of an effective system of the physical control of investment Partly also it was felt that the excess profits were wholly due to government orders so that to tax them away would not damage

[1] It is argued by those who give a very high priority to the redistribution of income through public finance that an additional profits tax is desirable in order to tax more highly the larger property incomes than would be possible through income tax alone effectively to impose a more than 100 per cent tax on disposable incomes In assessing this policy it should not be overlooked that the small property income will be relatively more damaged than the large Further, in view of the poor productional arguments for the high taxation of undistributed profits, such a policy is doubtfully advisable as part of a normal tax structure

[2] As income tax is at present operated, with a lag of a year between the declaration of the profits and their taxation, a separate profits tax could act more quickly and so more usefully There is little doubt, however, that profits could be taxed more expeditiously within the income tax without too great disturbance to the administration

[3] For details of excess profits taxes in both wars, cf Hicks, Hicks and Rostas *The Taxation of War Wealth*

enterprise In the war of 1939–45 an Excess Profits Tax, tougher in nature and higher in rate than the old E P D , was imposed at a much earlier stage in the war, after a year's operation the rate was raised to 100 per cent

There is no doubt that in the special conditions in which they were imposed E P D and E P T both proved powerful instruments of forced saving and so broadly fulfilled their purpose They were, however, fundamentally clumsy and bad taxes, with hindsight in another emergency better means of achieving their aims might well be found This is especially true in view of the great experience gained in operating physical controls in the second world war and immediate post-war years, thus making it unnecessary to rely so heavily on fiscal means in a future emergency

Excess profits taxes are bad because tax falls much more directly on the margin of effort and enterprise than is the case with a percentage tax on total profits, even in war-time this is important They are bad taxes also because they put a high premium on cost inflation in order to avoid taxable excess, a practice which is all too easy to achieve in the hurry and scurry of war orders Habits of bad management and of extravagance acquired in war-time are not easily lost when times return to normal These results of an excess profits tax are the greater because the tax is known to be temporary, expenses incurred during the war to improve the position after the war carry a very high premium

In the lesser emergency of a cold war an excess profits tax is not practicable Exceptional profits must then owe relatively more to energy and enterprise than to government orders, so that the disastrous marginal effect of an excess profits tax becomes intolerable [1] Nevertheless some sort of

[1] This was demonstrated by the good sense of Parliament which in 1937 substituted a flat percentage tax on total profits (N D C) for the excess profits tax first proposed by the Chancellor (Mr Neville Chamberlain) to preserve stability in the rearmament phase In somewhat similar circumstances in 1952 the Conservatives found themselves obliged to impose an Excess Profits Levy in order to fulfil an election pledge They had the good sense to make it as short and as mild as possible

additional quick-acting impost on profits may be called for. In these circumstances there is no doubt that the answer is a straight percentage tax on all profits. Further, in view of the bad effects of an excess profits tax in any circumstances, and of the less extensive stabilizing work which it would need to do in a future emergency (because of the availability of other means), it is highly probable that the best solution for a major emergency also would be to rely wholly on a tax on total profits, rather than use it (as was done with N.D.C. in the second world war) merely as an additional safeguard where profits did not qualify as "excess".

Since 1947, however, there has operated in Britain a separate tax on total profits which has certainly not generally been regarded as temporary; moreover it has been continued during a period not all of which could claim to be even a minor emergency. We must, therefore, briefly examine its *raison d'être*. The first purpose of the post-war profits tax was mainly to gather revenue; it was clear that without some alternative the immediate loss of over £400 mn. accruing from the discontinued E.P.T. would have seriously disrupted the budget, and it was almost certainly impracticable to make this good out of income tax alone. Before long, if not from the first, two additional purposes were found for it.

The new profits tax differed from its predecessor N.D.C., not only in having a wider coverage, but also in being assessed at different rates on distributed and retained profits—or rather it was assessed at a single rate on distributed profits, with a "non-distributional relief" on retained profits. As time passed, this differential was several times expanded, until it reached 40 per cent (rate on distributed profits 50 per cent, and on retained profits 10 per cent). This differential served two purposes: in the first place it discriminated still more heavily against property income than a flat percentage would have done; in the second place the accumulation of reserves was encouraged, a policy that was further supported by a voluntary "dividend freeze".

We have seen reason to doubt the validity of this first

purpose on productional grounds, while the mere accumulation of reserves is only an indirect stimulus to capital formation, in the sense that firms may feel a greater propensity to invest when they find themselves liquid than when they have to borrow Against this must be set the greater unwillingness of the investing public to buy securities when only very small dividends can be expected The direct stimulus to capital formation given through the initial allowances is certainly more efficient if the purpose is to increase the rate of investment The decisive argument against attempting discrimination between distributed and retained profits is, however, the liability which accumulates on the firm over the course of years for the repayment of non-distributional relief whenever it is sought to distribute anything in excess of the current year's profits[1] (as may often be desirable both in the interests of the firm and of general economic stability) It is of course inevitable that the Inland Revenue should claim the repayment of back relief, otherwise a firm could effectively evade the higher rate of tax completely

It seems clear, therefore, that a profits tax which attempts discrimination between distributed and retained profits is, like an excess profits tax, only practicable over a strictly limited period, without this provision the post-1947 profits tax would have lost much of its attraction This discovery need cause no dismay because, as we have seen, in all normal circumstances its productional effects and most of its distributional effects could be obtained better through the traditional method of the single integrated income tax

[1] For a good account of the complications to which the discrimination of profits tax gives rise see *The Economist*, Nov 1951, especially 2nd Nov

CHAPTER XIII

CAPITAL LEVIES AND CAPITAL TAXES

§ **1 Income and Capital Taxes Compared** Besides taxes on net income and profits, whose case we examined in the last chapter, the other large category of general taxes consists of those assessed on the capital value of the taxpayer's wealth (or total property) Capital taxes share the advantage of income taxes over outlay taxes, that they can be closely adjusted to ability to pay, although it is difficult to adjust them quite so accurately, since like capital does not always yield equal income There are also several other points in their favour

The possession of capital gives its owner social and economic advantages—advantages both of security and of opportunity—over and above the income derived from the employment of the capital It is no wonder that this "capitalist's surplus" as we may perhaps call it was early recognized to be a "proper subject of differential taxation"[1] and was, as we have seen, the subject of the first progressive tax in Britain

Further, it was pointed out that the greatest cause of inequality of incomes was inequality of inherited wealth[2], a policy of redistribution which does not make substantial use of progressive capital taxes will make but little headway against this factor Finally, there is the consideration, which we have found to be important, that while high income taxes discourage incentive and enterprise and put a premium on evasion, capital taxes (even recurrent capital taxes paid out of income) are much less likely to have this effect, since the tax base is related to past action and not to present effort

There is thus a good *a priori* case for capital taxes, especially where rates of income tax would otherwise be very high

[1] As suggested by J S Mill
[2] Cf Dalton, *The Inequality of Incomes*

Against this must be set one possible drawback which in the past attracted a considerable amount of attention If capital taxes are not accompanied by a compensatory increase in real investment they may lead to "capital consumption"—a deterioration in the community's provision for the future, relative to its provision for the present This will only happen if saving, equal in value to the taxpayer's loss of capital, does not take place somewhere else in the economy—not a very probable state of affairs unless the capital tax is very heavy In any case this is a long period consideration, if a serious degree of capital consumption did appear to be taking place it could always be compensated by new public investment

Although the case for capital taxes would seem to be a good one from the point of view of the economy, we still have to take into consideration the taxpayer's preferences If he were to be presented with a tax bill of a given present value, extending over the span of his life, how would he prefer to meet his liability? Our analysis of the loss of surplus arising from outlay taxes indicates that he would usually prefer a straight income tax to paying outlay taxes as a condition of enjoying a certain range of goods and services, selected by the government Would he still prefer a straight income tax to paying over part of his property, while leaving his income relatively intact? This is the question to which we must now turn

In investigating this question we are primarily concerned with once-for-all capital taxes—capital levies as they are usually called[1] The unforeseen nature of a levy makes it inevitable that it should mainly be paid by disposing of assets In all other cases the taxpayer has some opportunity of making provision out of income for his liability, thus the capital tax becomes more or less a species of income tax The history of genuine capital levies which have actually been carried through according to plan is short, so if this were all with which we

[1] In practice arrangements generally have to be made for taxpayers to meet their levy payments in instalments, as forced sales would otherwise depress capital values unduly, but all the instalments depend on the single valuation

were concerned our question might seem rather academic in scope Death duties, however, at least when imposed at the high rates now in force in Britain, have so much in common with capital levies that they can properly be included in the analysis of taxes paid out of capital

Since the fact of liability to death duties is known in advance, it is possible for people to "pay" death duties out of income, more or less completely, by insuring the value of their property at death, *net* of the whole, or part, of the death duty liability For owners of small or moderate estates the whole of death duty liability can be met in advance in this way, but owing to the sharp progression of the rates of tax on larger estates, their owners would not have enough left to support them during life if they attempted completely to discharge their liability in this way People thus have the opportunity of treating death duties wholly or partly as an income tax, but the statistics clearly show that they do not take advantage of this opportunity, in fact, it is very uncommon to insure against death duties Hence it is quite proper to treat them as a capital levy

The taxpayer's preference for a once-for-all levy cannot accurately be compared with his preference for an annual tax until we reduce them both to the same (either capital value or annual value) basis Various methods of expressing death duty liability as an annual tax have been suggested [1] No method of expressing a capital levy as an annual tax can be completely satisfactory and free from arbitrary elements or assumptions, since with a tax paid out of capital we are concerned with the future, and the future is always uncertain For the purpose of estimating relative preferences, however, what we may call the "income stream" method[2] seems to be the most satisfactory

This method proceeds by expressing the expectation of death duties on an estate (not merely the liability when the present owner dies, but at all subsequent turnovers) as a perpetual

[1] See Chapter XVI, Section 2

[2] Cf N Kaldor, "The Income Burden of Capital Taxes", *Review of Economic Studies*, IX (2)

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stream of equal annual payments, and comparing the size of this stream (i e, its present capital value) with that of a perpetual income tax[1]

Let us suppose that the taxpayer is confronted with the alternative of a perpetual stream of payments in the form of death duties, which imply a gradual reduction in the value of the estate, and an income tax which leaves his capital intact There must clearly be *some* rate of income tax which he would prefer to the necessity of handing on a smaller estate to his successor hence there must be *some* rate of income tax (which we may call the "compensatory income tax") which would cause him an exactly equivalent loss of satisfaction Is the present market value of this likely to be larger or smaller than the present market value of death duty liability? In the first place let us look at the matter the other way round Suppose that the taxpayer is offered the choice between paying death duties or paying an income tax with the *same* present market value (which would be of equal value to the revenue authorities), we may call this the "equivalent income tax" Would this be larger or smaller in value to the revenue than the compensatory income tax?

The taxpayer's preference between income tax and death duties depends on the rate at which he discounts his death duty

[1] The principle of the calculation of the death duty stream is as follows when someone inherits an estate he inherits with it a certain liability to future death duties This liability can be regarded as a fixed charge on the estate (similar to a mortgage except that it bears no interest) If we call the value of the estate K and the rate of yield on it i, then the income derived from the property is Ki If d is the fraction of the capital value payable in death duties, then Kdi is in the nature of a life interest for the present owner After his death the estate will be worth $(K-Kd)$, and his successor will have a life interest $(K-Kd)di$, and so on, for future generations, with the estate getting smaller and smaller at each turnover (It is possible, although more complicated, to allow for the fact that successive owners may add to the value of the estate during their lifetime) It should be noted that as the value of the estate shrinks, owing to the successive payments of death duties at each turnover, the tax liability on it (in respect of income tax as well as of death duties) is more than proportionately reduced, as it is pushed down into lower reaches in the schedules of progressive taxes This is some compensation for the loss of capital value due to death duties Cf Kaldor, *loc cit*

liability in order to estimate its present value to him Now death duties, unlike any other tax, do not require any personal surrender of either income or capital by the present owner of property It would seem likely therefore that the taxpayer will discount his future liability to death duties at a pretty high rate—distinctly higher than the market rate is likely to be This implies that the estate owner's estimate of death duty value is lower than the value the market (or the revenue) would put on it, by market valuations death duties are undervalued by estate owners Consequently, the income tax which has the same value to the estate owner (the compensatory income tax) will be worth less to the revenue than death duties (or the equivalent income tax) The government can obtain better value by imposing death duties than by imposing an income tax which inflicts the same loss of satisfaction on the taxpayer

Are the taxpayer's reactions to a once-for-all levy to be paid during his lifetime likely to be similar to his reactions to death duties? We can say pretty definitely that they are not Paying the levy involves some loss of income, but much more importantly it implies a sacrifice of opportunity and security It is likely that most taxpayers would be prepared to put up with a pretty stiff income tax which would leave their "capitalist's surplus" intact during their lifetime Consequently, it is probable that the gain to revenue from the compensatory income tax would be higher than the gain from the equivalent income tax (which implies the same benefit to the revenue as the levy)

We may thus conclude that death duties are superior to an income tax, in the sense that the government can raise a given revenue by means of them, with a smaller loss of satisfaction to the taxpayer than by an income tax In the same sense a capital levy, taken in the lifetime of the taxpayer, is inferior to an income tax A government which insists on imposing a levy when it might impose an income tax is throwing away the opportunity of raising a given revenue in a manner which would cause less loss of satisfaction to the taxpayer

§ 2 The Economic Effects of Capital Taxes and Levies We have seen that it is possible to reduce a single capital payment and an income tax to the same basis, with sufficient accuracy to make a sensible comparison of taxpayers' preferences The economic effects of death duties can be directly compared with those of an income tax, because death duties are a regular part (and in fact a rather stable part) of the revenue For the economy as a whole their effect is that of an annual tax and not of a once-for-all levy Although death duties are mainly paid out of the capital of the estates concerned, if the annual savings of the community are more than sufficient to absorb any assets that have to be sold in order to discharge liability, without causing any decline in the value of the national capital, for the economy as a whole, death duties are paid out of income, not capital

If death duties do not cause capital consumption in the economy as a whole their main economic effects are those arising from the greater equality in the distribution of wealth which is gradually brought about by the operation of the tax This more egalitarian distribution is in accordance with ideas of social justice, on the whole it is not likely to have unfavourable economic repercussions, and in an economy in which there is danger of oversaving it would tend to promote stability in consumption On the other hand the progression of death duties in the upper ranges of wealth has now become so high in Britain (reaching 80 per cent of the whole estate) that the process of the break up of property has been greatly, perhaps dangerously, accelerated from the point of view of the social provision of savings

The effect of death duties in accelerating the break up of landed estates was early noticed, because the exceptionally illiquid nature of the property, and the consequent fall in values as a result of forced sales to pay death duties, was partly at least responsible for the decay of farming capital which took place in the inter-war years It must be admitted, however, that much of this decay would probably have occurred independently due to the low prices ruling for agricultural

products This aspect of the effect of death duties is perhaps less important in the 1950's, partly because most large estates have been turned into limited companies, thus restricting the incidence of death duties to the individual shares, partly because the state now takes a big hand in assisting owners to maintain their productive farm capital

A more substantial case against death duties at their present level is the difficulty which small firms may be put to, not only in the raising of new capital (which is essentially a function of the decline in personal saving and hence only partly the responsibility of death duties), but actually in maintaining existing capital intact When a director who is also a large shareholder dies, the firm may not hold sufficient liquid funds for the executors to discharge his liability without selling some of the productive equipment employed in the business, a process that may obviously disrupt the firm's whole economy This hardship could be much mitigated if the revenue authorities were empowered to accept death duties in instalments

The economic effects of a once-for-all levy, imposed in the lifetime of the taxpayers, cannot easily be foreseen They depend to an enormous extent on the particular circumstances of the time and place—on political and fiscal circumstances and institutions, as well as on economic conditions A levy requires very expensive administrative machinery, so that to be worth while from any but the purely political standpoint it must be large enough to bring in a really effective revenue A levy thus amounts to a major surgical operation on the body economic, it will be either a kill or cure, and very different in its effects from the regular dosage or massage applied by the normal tax structure [1] In most levies that have been attempted or planned, the order of magnitude has been sufficient to

[1] In a plan for a levy, prepared by the British revenue authorities for the Select Committee on War Wealth, after the war of 1914–18, the number of levy payers was estimated at five times as many as the number of estates on which death duties were paid in any year, in spite of the use of a relatively high (£5,000) exemption limit The *amount* of capital to be surrendered at the rates proposed was estimated to be thirty to forty times as much as the amount annually surrendered in death duties Cf Hicks and Rostas, *The Taxation of War Wealth*, cit, pp 253–5

swamp most of the effects of normal public finance for the time being

In principle the initial effects of a levy are expected to be deflationary, if only because of the disturbance to business programmes and capital markets caused by the spate of capital transfers which the levy calls for, in order for the levy payers to obtain liquid funds to discharge their liability For this reason in the immediate aftermath of war, it is common that a levy should be proposed for the purpose of combating the tendency to inflation, which is an inevitable legacy of war finance In practice levies imposed in these circumstances may not have the desired effect, but rather the opposite, this was certainly the experience of almost all the countries which attempted levies in the 'twenties [1] If, as normally happens, loan facilities have to be made available for levy payers to discharge their liability in a form that is manageable for the government, and if in fact a considerable part of the levy is thus paid out of new borrowing, the effect will be anything but deflationary It is as little likely to be so as a levy actually imposed in war-time

The main reason why the levies of the 'twenties turned into violently inflationary measures was, however, the failure of governments to impose adequate exchange control, so that capital flight put the governments to the necessity of increasing their own borrowing (either by loans, or more likely by expanding the note issue), at an ever faster rate, in order to cover their current needs Even with better machinery for exchange control levies are difficult tools to handle, and it is desirable to be certain, both that the objects they are designed to achieve are really necessary and that they are not attainable by gentler methods

Capital levies are exceptional remedies, it is only exceptional emergencies which bring them into the forefront of discussion During the emergency itself to carry through a levy would in any case be impracticable, and it is generally recognized that it cannot safely be used for current purposes, even in war-time

[1] Cf *The Taxation of War Wealth*, *cit*, Chapter XXIII

Once the emergency is over, however, a levy can very reasonably be suggested as a means of ridding the country of the millstone of debt which has been accumulated during the emergency [1] When a levy is advocated as a means of paying off a large part of the National Debt there are really two arguments involved, one that the *capital* of the debt is too large, the other that its *annual cost* is too high

It cannot be regarded as self-evident that it is desirable to repay a substantial part of even a very large national debt, when we reflect that the destruction of such a large amount of private property must necessarily have very disturbing and deflationary effects at the time when the operation takes place The question of whether, and when, it is desirable to make an exceptional effort to pay off debt involves the whole policy of public finance and its relation to the national income, consequently, it is a question which we must discuss more fully at a later stage [2] The argument for a levy on the grounds of the high annual cost of the debt (in terms of the income tax necessary to finance it) rests on a more substantial basis The case for the levy is essentially the case against a high income tax, and that as we have seen is a good one

If the object of a levy is to permit a reduction in income tax, its efficiency must be judged by the extent to which the repayment of debt would cause a net saving in the revenue bill For a levy of any given structure this depends on three factors first, the rate of interest which has to be paid on the debt (determining the revenue required to service a given volume of debt, and consequently the revenue saved by paying it off), secondly, the extent to which debt interest is subject to income tax, and the capital of the debt is held by income taxpayers (determining the extent to which debt holders will furnish their own interest by their tax payments), thirdly, the extent to

[1] A levy may also be desired as a means of inflicting a tardy justice on war profiteers A levy which is *confined* to the increment of wealth during the emergency cannot be expected to cover its cost, so that in practice an increment levy is generally accompanied by a general levy on wealth

[2] Cf Chapter XIX

which the revenue normally relies on progressive taxation (income tax and death duties), since the revenue from these will be heavily reduced with the disappearance of the debt as a form of taxable property, and its interest as a source of taxable income

In Britain all these factors are now unfavourable for a levy Interest on the National Debt is subject to income taxes, and, as we know, the revenue is very dependent on progressive taxes, so that the loss of future receipts from surtax and death duties would be heavy Consequently, the repayment of even a large amount of debt (say, 50 per cent of the capital) would permit only a moderate reduction in income tax [1] In the 'twenties fiscal conditions were more favourable for a levy than in the 'forties or 'fifties, since the average rate of interest on the debt was substantially higher, and the progression of taxation less steep

With given fiscal conditions and distribution of debt holdings, the amount of saving in the revenue bill which a capital levy would permit depends on the structure of the levy—the height of the exemption limit and the steepness of its progression The lower the exemption limit is set, and the milder the progression, the greater will be the reduction in rates of progressive taxes which can be accomplished when the debt service is reduced by the repayment of the principal This is because a surrender of capital by citizens from whom the government derives only a small part of its surtax and death duty receipts will not seriously eat into the future revenue from these taxes Even in British conditions a *proportional* levy might permit a substantial reduction of income tax, of the order of about double the reduction which could be accomplished by a levy whose progression was comparable with the present progression of death duties A proportional

[1] In *The Taxation of War Wealth* an estimate was made on the basis of the 1938 distribution of wealth and structure of income tax, the net saving in income tax did not exceed *6d* in the £ In conditions of the 1940's, the continued fall in interest rates and rise in tax progression implies that it would have been considerably smaller Cf *The Taxation of War Wealth*, *cit*, Chapter XXIX

levy might, however, not be in accordance with ideas of social justice It would be equivalent to a reduction in the progression of the tax structure, from the time of the levy, until such time as capital losses could be made good by new saving

§ 3 **The Technique of Capital Taxes and Levies** We have yet to consider the technical problems involved in the assessment and payment of a levy, assuming that conditions are favourable (especially that the levy is accepted by capitalists), and that it has been decided to impose one So far as assessment is concerned the problem differs only in degree from that of other capital taxes, such as death duties The fundamental obstacle to all capital taxes—and indeed all property taxes—is the difficulty and expense of finding fair values (normal selling prices) for the property involved [1]

In respect of British death duties indeed a reliable and equitable technique of valuation has gradually been built up Valuations are made on the basis of executors' returns, checked over by Inland Revenue officials A substantial proportion of property consists of securities quoted on the stock exchange, for which, in normal times, reliable selling prices can easily be obtained Professional valuers are available for household effects, antiques, jewellery and the like More serious difficulties are met with in valuing real estate, but by far the most serious of all are concerned with the values of shares in (or assets of) small businesses In many cases values are only agreed (and consequently liability determined) after prolonged negotiation between accountants, executors and the Inland Revenue This is a further difficulty (in addition to that discussed on p 207 under which the small firm labours in respect of death duties

Yet valuation for death duties is a relatively simple matter The number of estates falling in year by year is fairly stable, and in most years capital values are sufficiently steady to ensure that no greater hardship will arise if liability cannot be determined for some little time after the death has occurred If the

[1] For a more detailed examination of valuation problems, cf Hicks and Rostas, *op cit*, Chapter XXVIII

methods of valuation employed for some types of property are not always very perfect, at least the owners of the estates are no longer there to complain, and comparison with similar estates is not easy There is every reason to believe, however, that, by and large, the revenue from British death duties is collected with as much equity and economy as that of any other tax in the structure

Few of these favourable technical factors will usually be present when valuations for a once-for-all levy have to be made In the first place the very magnitude of the task implies that experienced valuers cannot be available in sufficient numbers (either for the government if it makes the valuations itself, or for the property owners if they are required to make returns) for the valuation to be carried through within a short period This is serious because the levy is likely to be imposed in conditions of anything but stable values Besides enhancing the difficulty of determining fair values, rapidly changing prices cause great inequity between those who discharge their liability early and those who postpone payment as long as possible

Even when the problems of valuation and assessment have been surmounted, there remains the difficulty (negligible in the case of death duties) of absorbing the transfer of a very large amount of property without necessitating forced sales, and a consequent change in the relative values of different types of property, if not a general fall in values If levy payers hold war loan in sufficient amounts to cover their liability, the transfer problem is relatively simple, but this is a most unlikely state of affairs, and even then they may not be prepared to part with their most liquid asset Thus the government will have to make arrangements for a number of alternative methods of payment, and may even have to be prepared itself to take over temporarily all sorts of heterogeneous property, in order to support values in the interests of the community

In view of these difficulties, when a levy has been decided upon, there is a strong temptation to resort to less exacting

methods of valuation and to be content with low standards of collection Thus, instead of attempting to find market prices, property values may be "presumed" from income—often on the basis of income tax returns which are themselves far from perfect[1], and in order to get some revenue in quickly an amount of evasion is condoned which would not be tolerated for regular taxes

If a levy has to be thus debased in order to carry it through, it can confidently be affirmed that it would have been better not to have attempted it Acceptance of a lower degree of equity than would be tolerated in other taxes may damage the whole standard of the financial administration, a bungled levy may easily have the reverse of the intended effect, both politically and economically, and serious delays in collection imply a prolonged uncertainty overhanging the business community, which is at least as likely to damage enterprise as an income tax

§ 4 Capital Taxes as an Alternative to High Income Taxes So long as the main object of the levy is the avoidance of high income tax, rather than a reduction in the principal of the debt (an object with which we are not here concerned),[2] it is desirable to consider first whether it is not possible to lighten the incidence of income tax on enterprise and incentive (at a given rate of tax), by altering the method of assessment We have seen that there is room for improvement in this respect in British income tax In principle a still more eligible alternative to the levy would be a small annual tax based on capital values Although this would doubtless be paid out of income, it should be decidedly less restrictive than a normal income tax bringing in the same revenue since it would only be very loosely related to effort The obstacle to this alternative in practice is again the expense and difficulty of valuation

[1] Of this method of valuation the British revenue authorities remarked (in the memorandum referred to above, p 207) "To call the result a capital valuation would be an abuse of language"

[2] But see Chapter XIX

If the capital tax is not to sink below the standard of the rest of the tax structure in equity, not merely should all property be valued at estimated market prices by death duty methods, as for a capital levy, but valuations should be kept in line with economic conditions by periodic revisions—say, every five years The expense of revaluation has always been the stumbling block with property taxes, even with simple taxes on land and buildings such as the British local rate For a tax on total capital the operation would be enormously more complicated, and any failure to carry out revision would lead to much greater inequity

In British conditions it is unlikely that a capital or general property tax would improve the tax structure, but circumstances may well differ elsewhere In Scandinavia and Germany the wealth tax has been found a useful means of collecting tax from the proprietors of small businesses, especially retail traders, where income tax is often a failure The difference appears to lie in the first place in the much greater proportion of very small businesses (as compared with Britain), and secondly, in the smaller practice of incorporation (making it more difficult for the revenue authorities to determine net income) In turn, this difference is no doubt partly due to the traditional use of a separate corporation tax

As with a levy, so with a capital tax, it is only too likely that an easy way would be sought out of the valuation problem, and in practice the tax would come to be restricted to particular forms of property, probably mainly to real estate, or where an effective income tax exists, to stock exchange securities Most actual property taxes were in original intention capital taxes While there may be a place in a tax structure for an annual tax on real estate,[1] to impose an additional levy on a particular form of property for a purpose which it could not achieve would be worse than useless Moreover, some of the objects of the capital tax could be achieved by a much simpler method—by introducing (or increasing) the discrimination

[1] See Chapter XV, Section 5

against income from property which is already a feature of some income taxes.[1]

A high rate of tax progression inevitably gives incentive for evasion in the upper ranges; so far as this is "illegal" there is no remedy for it beyond greater vigilance on the part of revenue authorities; so far as it is "legal" it must be the endeavour of finance ministers to stop up every possible loophole by gradually improving the structure of the taxes. So far as death duties are concerned the main trouble is the gradual reduction in the size of the estate before death by gifts *inter vivos*.[2] In the case of surtax the greatest danger lies in the substitution of (tax free) capital gains for income. There are a number of ways in which this can be done.[3] In a small director-controlled company profits may be retained in excess of what can usefully be employed in the business in order to distribute them later as capital bonuses. More generally, in times of rising values, especially of real estate or stock exchange securities (which may, of course, be no more than the reflexion of an autonomous fall in interest rates), investors tend to buy and sell property not for the annual return which it will give them but for the far larger capital gains, of which they can be virtually certain. In principle a promising method of counteracting these types of evasion would be to extend death duties to cover all gifts and gains on the transfer of capital.

In economic principle there is a plausible case for taxing capital gains, since in many, perhaps most cases, they fall within the definition of income as that which can be spent without injuring the capital position of the owner.[4] In this sense capital gains are part of "disposable income" as truly

[1] The "earned income allowance" in British income tax (see p. 185) in practice has this effect.

[2] Gifts within five years of death are now included in the estate for British death duties. This safeguard is hardly yet sufficient.

[3] Cf. p. 180. A famous loophole was the practice known as "bond washing". Bond holdings were disposed of when the price was high because interest was shortly due, on the understanding that they would be bought back again when the coupon had been detached, i.e., at an "ex div." price.

[4] See above p. 179.

as the normal income stream, and add as much to the economic power of the owner In the United States where there is much sensitiveness to economic power (which carries with it a danger of political power also), the taxation of capital gains is held by many to be an indispensable completion of the personal income tax, other countries have also experimented with capital gains taxes It cannot be denied that in the absence of a capital gains tax very high rates of income tax may be insufficient to control excess spending in a period of inflationary pressure

The fiscal difficulties of an equitable tax on capital gains (which should logically give symmetrical relief for losses) are, however, formidable and it is doubtful whether they can ever effectively be surmounted The economically correct time to tax a capital gain would clearly be when it occurs, but in practice gains can only be taxed when they are realized, which may be some considerable time later, thus the tax loses much of its potential compensatory force and some of its equity Again, in practice, it is not feasible to give symmetrical relief for losses because they can too easily be used as a means of tax evasion

There is the further difficulty that by no means all capital gains are advantageous or desired by the recipients Company liquidations or bonus distributions which are to the advantage of the large shareholder,[1] anxious to avoid the higher range of surtax, may damage the small shareholder whose interest is in a steady income and who finds himself suddenly pitchforked into a high surtax range as the result of an unwanted "gain" The most awkward aspect of this difficulty occurs in times of generally rising prices or falling interest rates, when virtually no transfer of property can be made without realizing a gain in money terms, although in real terms it may actually represent a loss relative to the change in other economic categories, such as wages

In view of all these difficulties governments have usually fought shy of treating capital gains as on all fours with the

[1] Assuming that capital gains are taxed at a lower rate than other income, as is usual

normal income stream The rate for the capital gains tax has been set well below the upper surtax ranges, thus inviting to surtax evasion Relief for losses is usually very meagre An attempt is sometimes made to distinguish between unwanted and planned gains by setting a much higher rate of tax where the asset has been held only a short time None of these devices, however, is more than a palliative

It is thus at least arguable whether the addition of a capital gains tax is of benefit to the tax structure Again much depends on circumstances the political and economic importance of wealth in the economy on the one hand, and the expertize of the revenue authorities on the other It is clear in any case that the theoretical advantages of a capital gains tax can only be very imperfectly realized in practice In Britain most of the trouble of undue retention of profits in a director-controlled company has been avoided by giving the Inland Revenue power to tax excess reserves at surtax rates, according to the several interests of the proprietors, just as if they had been distributed The strongest apparent case for a capital gains tax is to deal with inflationary pressure, but here also lies the greatest danger of inequity and hardship In many, perhaps most, situations in which there is a rapid rise in prices or fall in interest rates (as there was in Britain in the years immediately after the second world war), which gives rise to widespread and conspicuous capital gains, they are more properly considered as evidence of faulty economic policy outside the fiscal system and can presumably be dealt with by more appropriate means

How urgently additional means for preventing evasion of progressive taxes is required, only the revenue authorities can estimate It is well to recognize nevertheless that, in spite of the high degree of efficiency which has been achieved, the British system of direct taxes is by no means perfect

CHAPTER XIV

OTHER TAXES WITH GENERAL EFFECTS

§ 1 **Taxes on Overheads** When we were discussing the method of tax analysis, we saw that there were some taxes, which, although they were imposed on particular ways of enjoying or spending wealth, were of such transcending importance in the economy as to influence directly the factors determining the size of the national income Such taxes require a general analysis, in addition to the partial analysis normally appropriate to outlay taxes

Possible varieties of such "general" outlay taxes are those formally assessed on an important domestic overhead (such as a tax on houses and land), or on consumption in general (such as a non-selective sales tax), on the one hand, on the other are taxes formally assessed on production, either on general industrial and commercial overheads (such as a tax on factories and business premises) or on running costs (so-called gross income taxes and turnover taxes and wage taxes)

We have already noticed[1] that if it is assessed at a high poundage, the British local rate will affect building adversely, and so will influence the general tempo of investment in the economy A similar effect on building is likely to result from any real property tax, except one imposed only on the increment of value of a site due to the increased demand for its services [2] This is an exception which, in settled countries, exists in text-book theory rather than in the real world

We need not repeat here the analysis of the effect of changes in real estate taxes on the tempo of investment, we have seen that in respect of a tax on house property the adverse effects of

[1] Cf Chapter XI, Section 3
[2] *Ibid* , Section 4

a rise in tax can be largely compensated by means of housing subsidies In the case of industrial and commercial buildings, this particular policy cannot so easily be put into effect, but approximately the same result can be obtained by appropriate rebates in the income tax on undistributed profits for reserves which are applied to specified new building [1] In Britain, so far as industrial buildings are concerned, any restrictionary effects of high local rates must have been eliminated by the scaling down of rate liability by 75 per cent under the derating provisions of the Local Government Act, 1929

So far as commercial and office buildings are concerned, there has been no parallel relief It is tempting to see the effect of high rate poundages in restricting new building on business account in the very extensive transfer which took place in the 1930's, of buildings which had hitherto been dwelling houses, to office and warehouse use It was this movement apparently which enabled the distributive trades to finance a very large expansion with remarkably little new investment

In general such a transfer of the purpose of a building is not a movement which the community should encourage The need for additional dwellings is likely to remain high for a considerable period, and if premises conveniently situated in the centre of towns or in the inner suburbs can be divided and converted to modern housing standards, it is in many ways preferable to further extensions of the outer suburbs On the other side, house property is seldom convenient for business purposes This effect of local rates on building could be counteracted either by inducing firms to build afresh for office and warehouse purposes, by means of appropriate income tax rebates, or by a subsidy for the division and modernization of dwelling houses

§ 2. The Incidence of Social Insurance Contributions In Britain the most important tax on current outlay is comprised in the social insurance scheme, in considering British

[1] Cf p 196

conditions it is necessary to distinguish between the employees' and the employers' contributions Although we have decided that the employees' contribution must be classed as a tax because of its compulsory nature (and is consequently a poll tax on earnings), it cannot have the same effect as an income tax of similar magnitude and income distribution It is overwhelmingly probable that in the absence of a State insurance scheme the majority of workers would insure themselves voluntarily at comparable rates for the same purposes Thus the distribution of family outlay can only be altered to a very small extent by the existence of the compulsory scheme

In so far as the employees' contribution has general tax effects, so long as the scheme was confined to the "under £250" class, they were those of an outlay tax rather than an income tax of the type familiar in Britain, that is to say, the incidence of the tax was on consumption rather than on saving This effect was intensified by the fact that the contributions, being uniform, are regressive against income, falling more heavily on the unskilled workers who save less, than the more highly paid members of the scheme When the insurance scheme was extended to the whole community (in 1948), the incidence naturally became more like that of an income tax

Economically the incidence of the employers' contribution is more interesting To the employer his contribution to social insurance is equivalent to a rise in his wage bill, this rise he will incorporate in his selling prices, so that for the economy as a whole the tax leads to a more or less proportional rise in prices If, for example, we suppose that the employers' and employees' contributions are each 4*s*, we may regard the payments as equivalent to an all-round rise in wages of 4*s* accompanied by a charge on the workers of 8*s* Since the funds are distributed in income transfers, however, incomes rise *pari passu* with prices, consequently the net effect on employment and real incomes of a rise in contributions is likely (by the familiar Keynesian analysis[1]) to be zero—there being

[1] Cf Keynes, *General Theory of Employment*, Chapter XIX

nothing in the change which is likely to affect dispositions to save or invest

This absence of important effects of the employers' contribution refers, however, only to the internal situation The short term effect of a rise in social insurance contributions is to raise British prices relatively to others, and so to cut down exports, at the same time the rise in employees' incomes due to the extra benefits may stimulate imports, so that the balance of payments is weakened, perhaps from both sides The stimulus to imports is likely to be greater the more closely the system is confined to working-class incomes, since a larger part of higher incomes is probably devoted to expenditure on the services of home labour, and less on additional food and other imports

§ 3 **Other Taxes on Prime Costs** The other big group of taxes which we have to consider is that consisting of the so-called gross income taxes, turnover taxes and general sales taxes In the crisis of 1930 taxes of this nature were very widely imposed both in Europe and America, but Britain weathered the budgetary storm by other means The British purchase tax, however, belongs essentially to the same class of tax, although its general effects are very much damped down by the exemption of food and of low-priced articles

Whatever they may be called, and whatever the differences of detail, these taxes are essentially similar in effect They are regarded by producers as additions to costs and are added to selling prices The loss of producers' and consumers' surplus which eventually results will be determined in each case by the elasticity of the demand curve facing the producer, in the manner which we have already analysed with reference to partial taxes on outlay [1] It is not this result, however, with which we are here concerned, but with the effect on the economy of the general rise in prices, and consequent fall in real income, which follows the imposition of the tax

Whatever the details of the tax, it must impose some check

[1] Chapter IX

on consumption,[1] and as a result some check on investment, in the whole economy, relatively to that resulting, for instance, from the imposition of a net income tax bringing in the same revenue This is due to the fact that the incidence is on spending rather than on saving The check to consumption and investment will be the greater the more temporary the tax—or its new rate—is expected to be If the tax is expected to be very temporary, investment for the remote future may be stimulated, while more immediate opportunities are neglected In a federal constitution when taxes of this nature are adopted by the constituent States, additional complications and costs may arise through the distortion of production or marketing channels in order to by-pass high tax States This phenomenon was illustrated in the United States as a result of the State sales taxes imposed for the purpose of supporting local budgets in the crisis of 1930–31, and, as we have seen, has continued on an ever-increasing scale since

If the tax is imposed as a sales (or purchase) tax, it probably implies that the revenue is collected from the wholesale or retail stage of the productive process, this constitutes a small improvement on the tax on turnover In the first place, the later the stage of production on which the tax is assessed, the smaller the opportunity for a "pyramiding" of the tax by adding a fixed percentage to selling price at each productive stage (on an ever-expanding base), in order to recover the cost of the tax from the next purchaser[2] If attention is not paid to this phenomenon by the administration, the prices of some goods may rise by very much more than the amount of the tax Secondly, if the tax is assessed only on the merchanting stage, there is much less opportunity for inequity as between small and large firms, due to differences in the degree of integration, than if the tax is assessed on turnover in general From all this it follows that before attempting to assess the incidence of

[1] Unless we assume conditions of overfull employment and easy money, when this, or virtually any other tax which falls upon them, may be used by workers as a lever to raise wages For discussion see below, Chapter XVII

[2] Cf the analysis of the taxation of a monopoly, Chapter X, Section 4

any particular tax, consideration must be given to its administrative details

A tax assessed on the merchanting stage of production has the additional advantage over other varieties of general taxes on running costs, that a rebate can be allowed on goods intended for export Apart from this consideration, taxes of this nature, as contrasted, for instance, with social insurance contributions, tend to stimulate exports (by reducing the home demand for home-produced goods), without stimulating the demand for imports—since consumption as a whole is cut down A general sales tax may thus be of some assistance in strengthening a weak balance of payments

As has already been said, it is doubtful how far the British purchase tax, with its wide exemptions, can have important general effects, and still more doubtful whether it could have an appreciable effect on the balance of payments in a period of unrestricted consumption, it all depends on the rate at which the tax is imposed on different commodities In most circumstances as good a result on the balance of payments could probably be obtained from a proportional tax on wage earners' incomes, which would be both more in accordance with ability to pay, and would almost certainly lead to less loss of surpluses As we shall see later, however,[1] a tax of the nature of the purchase tax may be a convenient weapon to have in reserve for the control of consumption in cyclical conditions, because like all outlay taxes, reactions to it are extremely rapid

[1] Cf Chapter XVII

CHAPTER XV

THE THEORY OF LOCAL TAXATION

§ 1 The Financial Problem of Federalism and Local Government Problems of local finance and its relation to national finance are of universal concern to the countries of the world In many European countries the development of strong local government has been an essential part of the growth of the modern state at some of its most formative periods, dating from the time when the great cities, managing their own affairs to a very large extent, found it in their best interest to ally themselves with the national government in the common fight against feudalism In the Dominions and in America, national governments mainly came into being as the result of the voluntary union of what were in origin separate and independent settlements, the form of constitution which emerged was consequently more or less federative, in contrast to Europe where the unified state became the most usual pattern

In the modern world, in spite of this basic constitutional difference, the problems of central/local finance in a unitary state and in a federation differ in degree rather than in kind Nevertheless the varying degrees of political unification in different nations—reflecting differences in physical conditions and in social outlook, as well as differences in political origin—imply considerable variations in the relation between central and local financial institutions Broadly, three main political types, with their corresponding financial arrangements, can be distinguished Examples of all three have long existed, without there being (at least until recently) any marked tendency for them to change or merge

At one extreme is the effective federation[1] in which the

[1] Although it is formally a federation, the political and financial institutions of the U S S R conform more closely to those of a highly unified state than of a federation

powers of the member states are very wide—whether or not they actually possess residual constitutional rights—and their tax powers are correspondingly ample In these conditions national and regional governments frequently have overlapping tax rights, and much competition and confusion may result With modern revenue pressure, however, it is becoming apparent that the struggle is an unequal one, sooner or later the national government must seek to increase its hold on the tax structure, because it is responsible for the fundamental duty of defence in war-time, and in normal conditions, for the economic well-being of the nation These are services whose finance must be subject to no obstacles

At the other extreme is the closely unified state, which is by no means necessarily a dictatorship, but is nevertheless one in which local government has very little independent life of its own Local authorities may indeed be chosen by popular election, and may nominally possess considerable tax powers, but in practice they are subject to the agents of the central government, and so are not effectively in control of the manner in which the revenue they collect is laid out Typical of this arrangement is the so-called "prefectorial" system widely established in Europe by Napoleon, and still surviving more or less intact in a number of countries (especially France and Italy) Under the prefectorial system, although the local authorities are democratically elected, they exercise little real power, partly because they are only very intermittently in session, but mainly because their decisions and their budgets are subject to veto by the prefect

Mid-way between these two extremes comes what we may term the Anglo-Scandinavian compromise, a situation in which room is found within the confines of a unitary state for a considerable degree of local autonomy, exercised by local representative bodies, more or less continuously in session Supreme constitutional powers remain with the central government, and the subordinate governments cannot function outside their permitted sphere, or levy taxes to which they are not specifically entitled Nevertheless, the line of demarcation

between central and local functions is not usually rigid In Britain, for instance, the local authorities have from time to time considerably increased the scope of their powers through the medium of private Acts of Parliament

Although these three types of central/local organization have long existed, in the inter-war period they were all subjected to an increasing amount of pressure and criticism, the net result of which has been, in almost every case, to increase the hold of the central government The most striking example of this process was, of course, the Gleichschaltung of Nazi Germany, reflected in a milder form in her satellites, but in the United States and in the British Dominions the strain of two wars has led to a very remarkable increase in the influence of the national government The federations have thus been drawing nearer, in fact if not in law, to the British type of organization At the same time there have also been powerful centripetal forces at work in Britain, whose effect has been intensified by the greater central and regional control found necessary for war purposes between 1939 and 1945

This increasing pressure of national governments makes it necessary to examine afresh the questions of central/local relations Although the Anglo-Scandinavian compromise has behind it an impressive record of the development of social services on the one hand, and of political stability on the other, the basis of local autonomy on which it rests is to-day seriously questioned

§ 2 **The British Local Authority—Rates and Grants** As we have seen, in the last quarter of the nineteenth century the expansion of social expenditure which has led to its absorbing by far the largest part of public outlay in normal circumstances, had definitely begun Hardly any of this outlay was actually made by the central government, in the 1930's the local authorities were responsible for the administration of about two-thirds of the total Most of the rest was looked after by separate bodies, such as the social insurance funds and the Assistance Board, these might, however, be regarded more or

less as agents of the central government The explanation of this somewhat odd distribution of functions is partly historical, partly fiscal The "new" social services education, public health and, later, housing, naturally followed the precedent of poor relief—the one major service inherited from an earlier age—in being a local responsibility

Once they had been established on a nation-wide basis these services grew rapidly, the main financial burden falling initially on the local rate which was already sustaining the heavy cost of poor relief From the 1890's the growing burden on rates led to a gradual, although often grudging, expansion in exchequer grants to local authorities, especially for education, but it was not until the end of the first decade of the present century that any real change of policy took place The schemes which were then established for old-age pensions, health and unemployment insurance were all managed by centrally appointed agencies, entirely outside the orbit of the local authorities This new policy served not only to remove assistance of the elderly, the sick and the workless, partly at least from the stigma of pauperism (which carried with it political disabilities up to 1918), but also to relieve the pressure on the rates without the supposed "danger" of giving a grant for poor relief

Thus the administration of the greater part of the social services remained the responsibility of the local authorities county boroughs, administrative counties and county districts, in all more than 1,300 separate bodies From the point of view of local finance this implies that the greater part of expenditure is concerned with social services, but only about half the funds are derived from local taxation The difference between the £916 mn which local authorities were spending on current account in 1953 and the £436 mn which they raised in rates was almost wholly[1] bridged by grants from the national Budget

The roots of the present British local finance system stretch a long way down into history In the twelfth century local communities were already raising a "rate" to provide local

[1] Grants=£411 mn, other local income (gross)=£186

amenities and works—bridges, embankments and the like [1] By the reign of Elizabeth I all parishes were compelled by Parliament to levy a rate for the relief of the poor in their area, and by this time local communities were also carrying out other services for the national government, especially in connection with the administration of justice Alongside of the growth of central government in the sixteenth and seventeenth centuries the activities of local communities also expanded The modern development of city government may be dated from the establishment of "Improvement Commissioners"[2] in certain towns in the eighteenth and early nineteenth centuries, by means of private Acts of Parliament

Parliament gradually took a hand in generalizing by national legislation the powers and duties thus obtained sporadically by local acts At first as each new service was established on a national basis it was administered by a new series of *ad hoc* local authorities—e g, the poor law guardians, highway boards, sanitary districts and school boards—but in the second half of the nineteenth century local government duties were gradually concentrated[3] in the hands of general, non-specialized local authorities, and the country was mapped out so that it was completely covered by a network of representative governing bodies Although the number of separate jurisdictions was still large, this concentration of powers achieved a great simplification in local administration [4] As a result of a further (*de facto*) concentration of function since that date, it is now sufficient for most practical purposes to take account of the activities only of the county boroughs and administrative counties, that is to say, to consider only about 140 different bodies instead of 1,300

[1] Cf Cannan, *History of Local Rates in England*

[2] Thus the Liverpool Commissioners in 1744 obtained powers to carry out street lighting and cleansing, prevention of nuisances and control of vehicle parking

[3] The latest of the *ad hoc* authorities to be absorbed were the Poor Law Guardians, in 1929

[4] Strangely enough this concentration of functions has never taken place in the U S A where local administration is in the hands of some 175,000 separate authorities, many with overlapping jurisdictions

It will be apparent that almost from the first a local body was responsible for two different sorts of activities, those of its own choosing and those placed on its shoulders by Parliament There was, however, no satisfactory functional difference between the two sorts of activities [1] Services which enterprising communities took steps to provide for themselves were seen to be good for other places as well, and Parliament naturally wished that they should also be available for those who lived in less progressive—or less wealthy—neighbourhoods Thus services which were in the first place provided voluntarily and sporadically tended to become universal and compulsory on local authorities

As we have seen, the local rate was first used by local communities for the improvement of their own neighbourhoods, but following the precedent of the Elizabethan Poor Law, the additional services, when they were made compulsory, were also placed by Parliament upon the local rate Clearly there was a limit to the possibility of financing additional services from a single tax—a limit made all the more definite (as we shall see later) by the special characteristics of the rate itself, but since the Treasury jealously reserved [2] for the national Budget the right to all other taxes, it was inevitable that sooner or later Parliament should come to the help of local finance out of its own resources It is no accident that the first exchequer grant (1825) followed closely the enormous rise in the poor rate due to the Napoleonic wars

A natural consequence of Parliament's wish to generalize services was that it should also desire to generalize *standards* of service This policy calls not merely for grants in aid of average rate revenue, but for especially generous grants directed to those areas which are abnormally poor or whose needs in particular directions are abnormally great Once this policy is accepted, grants tend to become not only larger but

[1] Cf the discussion of the onerous beneficial distinction, pp 244ff

[2] The period of Goschen's "assigned Revenues" in the second half of the nineteenth century is only an apparent exception, the local authorities had no control over the rates of the taxes which were assigned to them

more complicated Differential grants in this sense have been of gradually increasing importance in the education service since early in the present century They were first given for general purposes in the Block grant, which in 1929 took the place of certain specific grants which had previously been given

§ 3 **The Political Importance of Local Autonomy** The sequence of events which we have followed *explains* the distribution of administrative and financial responsibility between the national government and the British local authorities, but does it *justify* either the one or the other? It is natural to ask whether it would not be better (granted that it is not practicable to enlarge the local tax base) to abolish the clumsy and perhaps dangerous apparatus of transfer of funds from the national to local exchequers, by transferring instead the administration of the services concerned to central control? In fact this process has been going on in Britain since early in the present century Not only did the policy of the "break up of the poor law", dating from the Reports of the Royal Commission of 1909, lead to centrally-controlled and financed old-age pensions, health and unemployment insurance, but the process was accelerated in the 1940's by the substitution of national assistance for poor relief, and by the absorption of a number of the health services of the local authorities in the national health service in 1948 During the inter-war period grants in aid from major to minor governments became increasingly important, not only in Britain but in many other countries, especially in the United States and the British Dominions,[1] so that the problem is of general interest It is clearly one which has two sides, political and administrative on the one hand, financial and economic on the other Although we are primarily interested in the latter, the two are so inter-related that we cannot ignore political considerations altogether

[1] Cf H J Bittermann, *State and Federal Grants in Aid*, Hansen and Perloff, *State and Local Finance in the National Economy*, Report of the Royal Commission on Dominion-Provincial Relations (Canada), the Reports of the Australian Grants Commission are also particularly illuminating in this respect

We have seen that local communities were already exercising a number of government functions for their own convenience at the time when Parliament began to develop public social services on a national scale Parliament was thus taking the line of least resistance in putting the administration of the new services under local control, but in fact this policy was largely inevitable in the then state of transport and communications on the one hand, and of the primitive condition of administrative technique on the other

Local administration has, however, traditionally had a deeper justification than mere technical convenience In the services concerned with the individual citizen and his family it is clearly most desirable that the administration should possess local knowledge and understanding This was especially held to be desirable for the administration of public assistance and public health For other services, e g , education and housing, it is equally necessary that the officers concerned should be familiar with local industrial and topographical conditions, if the citizens are to get best value for their money

Local administration does not, however, necessarily imply local control of the executive officers With modern communications and the development of the administrative machine it is possible—at any rate in a small country like Britain—for a decentralized national administration to pay almost as much attention to personal and local needs as one that is locally controlled In the inter-war period this was conclusively demonstrated by the success of the Assistance Board This discovery has largely cut the ground from under the argument that in Britain social services require local control Indeed there is an *a priori* case for supposing that the local branches of a central department will be more successful in providing uniformly good services than semi-independent local authorities

From the other side it is argued that with the spread of urban development over the countryside, and the increasing habit of living in one place and working in another which it

implies, statutory local authorities no longer have under their charge *communities* in any relevant sense On the one hand neighbourhoods have ceased to be physically and psychologically distinct, on the other the traditional jurisdictions of the local authorities have become too small for modern life

There is a good deal of substance in these contentions, and it is not surprising that they should be leading both to an actual extension of central functions and to a demand for the grouping of local authorities into larger "regional" units It is further evident, on purely economic grounds, that for the successful maintenance of a high level of economic activity, either the national government must undertake (directly or through public corporations) substantial types of investment—for instance, housing and highways—or it must have available much greater means of controlling the timing and intensity of local investment than it enjoyed in the inter-war period Thus it is inevitable that the status of local investment in the economy should be modified

Local independence in Britain is thus threatened from several quarters The threats are the more serious because they have the backing of the progressive elements in the country, the educationalists, the social workers, and all who put a high value on efficiency Yet there remains one basic argument in favour of autonomous local government which has at least as good claims to consideration as efficiency Moreover, it is an argument which the course of history is tending to emphasize rather than to weaken

The convincing argument for the preservation of local autonomy—and hence for something like the traditional British local government set-up—is now almost wholly political Recent history strongly suggests that the power of local initiative is a *sine qua non* of successful and stable democracy The reason for this is that live local government ensures an active connection between the citizen and the executive Complexity of political structure is actually a virtue because it multiplies the contacts between the governed and the governing The danger of destroying these additional contacts was

tragically demonstrated in France in 1940 To obliterate all traces of them has been a leading aim of authoritarian states

The spirit of democracy is in fact nothing other than the sense of political responsibility in the individual citizen It is true that the democratic virtues can be fostered by many types of association, both social and occupational (trade unions and even choral societies), but the organization of local communities into associations which are political in the sense of being partly self-governing has a special virtue in promoting a sense of political responsibility Local autonomy is a training ground for a far wider circle than the few who have ambitions to take a personal share in government

The political argument for local autonomy is so strong that it is right that it should be given preference even at the risk of some loss of efficiency It is necessary to consider carefully, however, with what type of autonomy the argument is really concerned It is essentially an argument for the independence of local *communities*, that is, of groups conscious of common local aims and interests It is obvious that in Britain such groups only exist on any scale that is administratively relevant in urban communities, although not necessarily only in the eighty-three major towns which at present enjoy the privileges of county boroughs The political argument for local autonomy, at least in England, is thus fundamentally an argument for the independence of town government In areas where no administratively convenient self-conscious units exist,[1] the argument for local independence is weak in comparison to the

[1] The size of the satisfactory local unit probably differs considerably from country to country, according to the type and density of the population In Scotland community life in rural areas seems to be stronger than in England, and the typical burgh is much smaller than the English town It is quite possible that in Scotland—or for that matter in France, which is in many ways similar—independent administration of small country areas would work well In the United States a population unit of 35,000 to 50,000 seems to find most favour (cf Hansen and Perloff, *cit*), on English standards this is rather low, cf the minimum for independent privileges recommended by the Ministry of Health to the Local Government Boundary Commission

high probability of the greater efficiency which would result from national or regional control

§ 4 National Standards and Local Inequalities There is thus a fundamental dilemma in local government—of balancing the political advantages of autonomy against the economies of large administrative units and the social benefits of uniform standards of social services This dilemma, with all the complications to which it gives rise, is far from being a purely British phenomenon It appears—and in a surprisingly similar form—in every country[1] which does not cut the knot by complete centralization, it is particularly intractable in the great federations, because it is then on a two-layer basis—federal, state or provincial and city or local It is especially important to find a solution in a country which wishes to follow a systematic policy of high employment

The factor above all which complicates the solution is the disparity between local wealth and needs In an advanced, and well-educated country, like Britain or the United States, there is no reason to suppose that one town cannot produce as able citizens as another for the local council (remembering that we are primarily concerned with urban communities of a certain minimum size), or that *given equal financial opportunity* equal administrative and executive ability is not available to all local authorities Minor differences, in ability and in tastes, are always to be expected, and do no harm (For instance, if Manchester has a special interest in its education policy and Birmingham in its public health, that is a matter for congratulation and not for discouragement, so long as other services do not suffer) There is no reason why such minor differences should have any systematic or lasting bias against the interests of particular citizens

Unfortunately, however, financial opportunity is not naturally equal, local communities differ enormously in wealth

[1] Cf Report of a "Conference on Problems of Reconstruction between the Birmingham Reconstruction Committee and Representatives of Some Cities of the Allied Nations", Birmingham, April 1944

from one another Just how wide the differences are is not easy to determine There is no completely satisfactory method of measuring local incomes when communities are interconnected, and many citizens effectively have dual local citizenship In the United States regional differences can be roughly measured by means of data of income disbursements In 1938–40 income per head ranged from $199 in Mississippi to $853 in New York State In Britain if valuation for rates were made on a uniform basis throughout the country, rateable value per head would provide a very fair indication of relative wealth, but under present valuation practice it would do less than justice to the differences [1] Some indication of the disparity between wealth and needs can be obtained by comparing rates per head, a calculation which allows for the equalizing effect of grants Thus the same expenditure per head in 1938 required in Manchester a poundage of between 16*s* and 17*s* while in Eastbourne it called for one of only 9*s* [2]

These rough figures give only a small indication of the complexity of the problem Differences in local wealth are partly a matter of whole regions being poor or rich together, or suffering more or less from booms and depressions They are partly a matter of the decay or rise of particular towns, whose trend is not necessarily in accordance with the regional trend A particularly intractable form of the problem to-day is the decay of heavily built-up areas near the centres of towns, as compared with the more modern and attractive suburbs When the city bounds cannot conveniently be extended to embrace the suburban development, even an otherwise prosperous city may be tipped downhill financially In all these situations the crucial point is that wealth is in inverse relation to needs, so that to finance a given standard of services requires, not merely a greater expenditure per head in a poor than in a rich town, but a much more than proportionately higher rate of tax, if the service is to be financed by local resources

[1] Cf Hicks (J R and U K) and C E V Leser, *The Problem of Valuation for Rating*, Part II, Chapter II, Section 1

[2] Hicks (J R and U K), *Standards of Local Expenditure*

The solution of the local government dilemma thus cannot be achieved by the national government merely handing over sufficient funds to local governments to enable them to reach a satisfactory average standard of performance, but not enough to destroy their initiative (i e , giving them no incentive to practice laying out their own resources to the best advantage), it is something much more complicated The solution requires the combination of a carefully adjusted differential grant system and a local tax system which minimizes the work which the grants have to do

§ 5 The Characteristics of a Good Local Tax Much less attention has been given to the consideration of the desirable properties of a good local tax than of a national tax, yet a little thought will show that they are by no means identical It is, of course, desirable that a local tax should—like any other—be convenient and certain, fair between persons similarly situated and economical in collection (This last is especially necessary since minor authorities cannot afford the skilled administration which is available to national governments) But the position of local finance in the economy differs from that of central finance in several respects, and this affects the type of tax which is required

Just as there must a basic difference between the ultimate tax powers of national and subordinate governments, so there is a parallel, almost equally inevitable, difference in their borrowing powers There is virtually no limit to the debt which a national government may acquire, so long as it retains the confidence of the citizens, the borrowing of subordinate governments on the other hand cannot be allowed to proceed indefinitely It is not beyond the bounds of probability that a subordinate government which can borrow to an unlimited extent may be able to defy the policy of the national government and even break up the nation [1] In a less critical situation than this, it is still very undesirable that a subordinate

[1] Cf especially the conduct of the Confederate States in the American Civil War

government should be allowed to drift into a position in which it is in danger of default (which might well occur if borrowing powers were unlimited) In a unitary state local default cannot be tolerated (consequently in Britain a fairly tight rein on local borrowing has always been held by some department of the central government, even when the loan was to finance equipment for a trading service) Even in a federation the whole basis of government may be compromised by the default of one of the members

It follows from this that regional governments should practise more or less the "sound finance" which is proper to private enterprise (which imples incidentally that if a deficit in the whole public sector is required for purposes of economic policy, responsibility for it must be borne by the national government) The first necessity for a local tax is therefore for one that will help subordinate governments to keep their finances on an even keel, in other words for a tax whose yield is reasonably stable in good times and bad Neglect of this principle brought the services of even first-class American cities to a standstill in the depression of 1930

The second desirable quality in a local tax is that its base should be localized within the jurisdiction of the taxing authority, only then can local authorities enjoy effective autonomy, because only then can they have effective control over their own budgets (It will be noted that under modern conditions an income tax fails to satisfy this requirement) Localization of base, however, gives rise to a new difficulty Owing to differences in wealth and needs, there is a real danger that a local authority which allows its rate of tax to become abnormally high will drive its taxpayers outside its jurisdiction Such emigration will land the local authority in question in cumulative difficulties Its overhead charges are rigidly fixed, and the possible economies in current outlay are strictly limited This difficulty is especially serious when local jurisdictions are small, because small areas give small opportunities for averaging wealth, and large opportunities for emigration From this difficulty two important considerations follow

It is most desirable to have a local tax which does not exaggerate local disparities in wealth This, it will be noted, cuts out for local use progressive income taxes of the British type Poor authorities could never hope to make both ends meet if they had to get most of their revenue from the few moderately wealthy people who alone would be likely to live within their jurisdictions Further, the danger of stimulating migration implies that there is a ceiling in relation to income above which it is primarily a matter of relative tax rates in one area and another, the higher the general level of local taxation, the greater will be the absolute differences in inter-local tax liability From these points of view a tax which is proportional, or even moderately regressive, is more appropriate for local purposes that a progressive tax, and should not be unacceptable on distributional grounds as long as liability is reasonably low in relation to working-class incomes

Finally, it is, to say the least, extremely convenient if the local tax can be reserved for local use Basically the purpose of this is to ensure local autonomy, but on other grounds also it is very desirable to avoid overlapping tax rights between national and regional governments When revenue needs are urgent, the major government must necessarily override the interests of the regional authority, and this leads to much friction, as well as to confusion in local budgets In both Canada and Australia there was much heartburning on this account between 1939 and 1945

Where interlocal differences in tax rates are large, overlapping rights may actually hinder the national government in the performance of its duties by driving up tax rates in some areas beyond the practicable limit (producing, for instance, income taxes of more than 100 per cent) Competitive exploitation of taxes is also a fruitful source of double—or even treble—taxation of the same income or commodity Finally, competitive exploitation has the important distributional disadvantage that it makes it impossible for the central government to regulate the rate of progression of the tax structure

In a unitary country it should always be possible to reserve

local taxes for local uses, and yet allow local authorities sufficient control over revenue to ensure their autonomy In a federation some overlapping may be inevitable if regional governments are to cover their legal functions, but it need not be extensive

§ 6 The Application to the British Local Rate Given these characteristics of a good local tax, we must next examine how far the taxes most frequently used for local purposes are appropriate for their task, and particularly the British local rate and its foreign counterpart the local property tax on real estate In principle it will be seen that a tax on land and buildings (which is by far the most common of all local taxes) has much to recommend it The tax base is unequivocally localized, and the yield is usually extremely stable Stability of revenue is no doubt partly due to the fact that valuations tend not to be kept strictly adjusted to changes in wealth, but fundamentally it is due to the fact that real estate is a highly "illiquid" form of property, its "velocity of circulation" is notoriously slower than that of other forms of property, so that its value is less volatile [1]

Secondly, land and buildings are much more "important" commodities in consumption than any others which are available for tax purposes, so that a given revenue can be raised with lower *per capita* taxes than by means of any other outlay tax [2] Thus subordinate governments can raise a large independent revenue by this means without running their heads dangerously near the ceiling [3] Finally, a tax on land

[1] This stability in yield seems to be much less fully realized in the United States than elsewhere In the past revenue from the American local property tax has fluctuated enormously with changes in the level of economic activity This appears to be mainly due to widespread defaults among property owners in depression (perhaps connected with unsatisfactory credit facilities), it may also be due to the relatively greater volume of land sales, and hence greater variations in value, in what is still, from many points of view, a new country

[2] Cf the analysis, p 148

[3] This advantage also seems to be less fully realized in the United States than in Britain, perhaps because of the undermining of the American tax base with exemptions, see next page In some states also a low ceiling to the property tax was deliberately written into the constitution

and buildings is one which it should be easy for the national government to refrain from poaching on, for emergencies, just because of its stable (and consequently unexpansible) yield, it is very little use, for normal conditions there is no lack of tax sources with similar incidence In the United Kingdom the local rate has always been left to the local authorities[1], in the United States there has recently been a very marked tendency to leave the local property tax to the cities and local authorities, so that the problem of overlapping jurisdictions and competitive exploitation is now practically reduced to the Federal/State plane[2]

In spite of these obvious virtues it is common to find the local property tax the object of much criticism and opposition, especially in countries which put a considerable weight on it Although the weight on the British local rate is not unreasonable,[3] it is not exempt from this criticism, so that we must inquire into its cause and validity

An obvious objection to real estate taxes as they are commonly practised is the use of out-of-date valuations of the property to be taxed This is partly due to the limited financial resources of minor governments, especially where jurisdictions are small The tax is not in principle "uneconomical", but it is rather difficult and expensive to determine the base correctly Valuation is a skilled job, and a thorough revaluation requires the service of expensive personnel for a considerable period Consequently valuations tend to be scamped, or postponed, until with the passage of time they become quite out of line with each other and with the facts

Probably the best cure for this difficulty is to transfer the duty of *valuation* (but not, of course, of assessment or collection) to a central body, placing the cost on the national exchequer[4] This would not only promote uniformity of

[1] The seventeenth-century land tax was essentially an income tax, cf p 121

[2] Cf the account of the U S tax structure, pp 78ff

[3] Cf the estimates of formal incidence, pp 260ff

[4] In the U K this was done by the Local Government Act, 1948, see p 242

valuation practice, and so substantially increase the equity of the tax, but would in itself tend towards equalizing interlocal financial opportunities (by removing from local financial shoulders an expense which is especially heavy in small districts), without in any way diminishing local financial autonomy

Out-of-date valuations are an important cause of inequity in a local property tax, but they are not the only one In the United States arbitrariness arises from (very varying) attempts to include property and even intangibles in the tax, the British local rate in the past went through similar troubles There is no doubt that it is better to confine this tax to real estate, which can be taxed equitably with relatively simple administrative machinery, indeed many of the advantages of the tax for local purposes depend on its scope being thus limited A still more important trouble (again illustrated in the United States) is the multiplication of exemptions from the tax, partly with a view to vote catching, partly as a concealed subsidy, e g , to home owners The result is to drive up the rate of tax against those who cannot claim exemption, and thus (in addition to the inter-personal inequity) to limit the revenue which can be raised, while at the same time making it less stable

Although the British local rate is not riddled with exemptions, its incidence on different types of property is at present unnecessarily arbitrary Since 1929 agricultural land and buildings have been given an exemption which would better have been awarded as an open subsidy, shops and offices are burdened in comparison with partially derated industry, the methods of valuing crown property and public utilities are arbitrary and uncertain More serious than these anomalies (because about 60 per cent of rate revenue is derived from them) is the situation concerning the valuation of dwelling houses Since there was no provision for regular revaluation, although valuations were properly based on free market rents, as was legally required, on the eve of the first war serious differences had already arisen depending on the date of valuation These differences were then frozen by the rent control of the first

world war When (in 1925) provision was made for regular quinquennial revaluation the position had been further complicated by the tendency for valuers to value the new houses by analogy with the controlled rents of old houses of similar size, rather than seek a current (and of course considerably higher) market rent Since in addition the new houses tended to be smaller than old houses of similar standard of accommodation, this practice gave rise to a situation in which new houses were generally undervalued relatively to old, from this it arose that whole areas might be substantially undervalued relatively to others, depending primarily on the number of small new houses within their boundaries This was a serious matter, since from 1929 rateable value per head came to be one of the elements on which the amount of the general exchequer contribution to local revenues was based

Probably only valuation by a central authority could have straightened out the intra- and inter-local valuation anomalies which had accumulated by 1939, it was therefore in principle an improvement when valuation was (by the Local Government Act 1948) transferred to the Inland Revenue By that time, however, the total rent control of the second world war had once more frozen relative values in the accidental relation into which they had drifted, at the same time it had indefinitely postponed the day when a return to the traditional basis of valuation (the free market rent) could be made Out of this quagmire no government has yet been able to devise a scheme which would once more place the valuation of dwelling houses on terra firma [1] In respect of grants the situation is now even more serious, since (as we shall see) the equalization grant of the Local Government Act 1948 depends to a still greater extent on uniform valuation This erosion of the base of the local rate is a melancholy factor in the situation which has to be borne in mind, at the same time it can hardly be said to destroy the basic arguments in favour of the rate as a local tax

[1] The Rating and Valuation Act 1953 may provide a first step, it is as yet too early to say

Besides objections brought against the practice of existing local real estate taxes, two objections of principle are frequently brought against them It is pointed out that from the point of view of the local authorities the revenue is inflexible and rigid, while from the point of view of the taxpayers it is regressive against income The former limitation is especially felt by the larger and wealthier local authorities who have ambitious plans for neighbourhood improvement Our analysis has shown that this inflexibility is inevitable, and is in fact part of the virtue of the tax, since it is only the other side of stability Undeniably, wealthy cities would be better off if they were allowed to exploit a progressive local income tax, but if they did so it would make things harder, both for the central government and for their poorer neighbours Local ambitions cannot be given free rein without upsetting the balance of the national economy

Our analysis also shows that moderate regression is not necessarily an objection in a local tax, to some extent it is an inevitable accompaniment of its equalizing properties All outlay taxes have some degree of regression, that of rates is less severe than of many other outlay taxes [1] Regression, however, only remains acceptable so long as the national government retains control over most of the rest of the tax structure (so that the over-all rate of progression can be adjusted), and so long as the rates of the local tax are moderate This implies that if it is constitutionally necessary for minor governments to undertake duties which are beyond the resources of the real estate tax, they should be given additional sources of revenue before the danger point in the real estate tax is reached

It would take us too far afield to discuss adequately appropriate extensions in the local tax field, it is mainly a federal problem and the best solution depends on local conditions, which may differ widely In a new country there may be scope for a tax on land values, other taxes with reasonably localized sources are entertainments duty and motoring taxes,

[1] Cf the estimates of formal incidence in the next chapter

especially vehicle licence duty All of these have the advantage that they could be vacated by most national governments[1] without undue inconvenience, that they are not unduly regressive and that they need not involve double taxation or interlocal tariffs against trade and industry

§ 7 **Equalization through Grants** A satisfactory local tax greatly facilitates the solution of the dilemma of local finance, but it can never provide a complete solution Unless the powers and duties of local governments are to be more limited than is desirable on political grounds,[2] exchequer grants will be necessary for equalizing purposes, they may also be needed as a supplement to local resources to prevent the general level of local tax rates from becoming too high (In addition it may also be desired to award grants to stimulate the expansion of new services, this policy although admirable in itself actually—as we shall see—increases the difficulty of solving the main problem)

In any grant system there are thus two major policy problems to solve, one concerned with the over-all size of grants in relation to total local financial resources, the other with the distribution of grants between local authorities differently placed [3] It would take us too far into the administrative

[1] The proportion which total revenue bears to the national income is also relevant Where revenue needs are light the obvious advantages of a *proportional* income tax for an upper layer of regional governments are so great that its disadvantages may be overlooked

[2] At the same time the existing powers and duties of local authorities should not be regarded as sacrosanct In Britain, e g , there is scope for a further transfer of highway services from purely local control, besides perhaps fire brigades which were a national service during the war

[3] Mention should be made here of the traditional method whereby it was sought in Britain to solve both problems at once—namely, by the distinction between *onerous* services (mainly those imposed by the national government), and *beneficial* services (essentially neighbourhood improvements), the former to be grant aided, the latter to be financed wholly from local resources From the first the distinction was vitiated by the refusal of the central government to make a grant for public assistance, the most onerous and disequalizing of all forms of local expenditure In a situation in which neighbourhood improvements may be made compulsory, and income redistribution is accepted as a national policy, the distinction loses any precision it once had, or any usefulness as a directive of policy

field to discuss these questions in detail, but a word must be said on each in order to complete our analysis of the more limited fiscal problem

The danger of very high grants is that they will lead to irresponsible spending This is probably less true of an equalizing grant based on some objective measure of needs, and available for general purposes, than of a specific percentage grant for a particular service, the latter may have the effect of seriously distorting local budgets The natural reaction of central governments to the danger of irresponsible spending is to attempt to increase control, as grants expand Since this is to destroy local autonomy it should be avoided as far as possible There is little doubt that a higher standard of good spending could be achieved if the national government were to aim (by precept and practice) at a higher standard of local authority costing and accounting By these means central departments would have a better effective control without any inevitable increase in day-to-day interference with administration

At the same time, if a policy of increasing urban local autonomy is followed (as is here suggested on political grounds) a time will come—in Britain at no very distant date—at which some counties can cover only a very small part of their needs out of rates In those conditions an amalgamation of areas under national or regional control would promote efficiency without sacrificing anything of political value, since there is little county consciousness in most areas, apart from the question of cricket

Up to the second world war, the effect of differential grants in securing uniform services in Britain was slight One important reason for this was the extensive use made of specific grants for particular purposes, especially for education Percentage grants are disequalizing because only well-off authorities can take much advantage of them, since in accepting the grant they inevitably increase their own responsibilities also After the grants have been in operation some time therefore the standard of services in poor and rich areas begins to diverge

markedly[1] If, finally, it is decided to provide adequate differential help, the task of equalizing services will have been made more difficult, and the government will find itself committed to substantial positive grants to the wealthier authorities

The basic problem of a successful differential grant is, however, the choice of an objective and secure basis for measuring the inequalities in wealth and needs which the grant is required to rectify The first major attempt in Britain was the "Block Grant" (General Exchequer Contribution) of 1929 This worked through a complicated formula of weighting population by factors presumed to allow for exceptional poverty or exceptional needs low rateable value per head, high percentage unemployed, large number of children under 5, and in rural areas, sparsity of population per mile of road The grant was fixed for five years at a time, an arrangement which had the advantage of certainty both for the central and for local budgets, but the disadvantage of inflexibility As an equalizer this grant proved a very weak instrument, this was partly because the grant (and especially the equalizing element in it) was small both relatively to other grants (some of which were definitely disequalizing), and even more in relation to the great disequalizing force of public assistance expenditure during the depression It was also partly because some of the wealthy authorities were eligible for quite substantial grants under it

In 1948 a much more equalizing grant was substituted This was based (apart from a nominal weighting for children and sparsity) squarely on the difference between rateable value per head in the area and the national average, and on the actual "needs" of an area as determined by its expenditure This grant, moreover, is adjusted from year to year[2] as soon as local expenditures are known Further, grants are available

[1] A striking instance of this was revealed in the backwardness of tuberculosis services in Wales in the 1930's

[2] A committee investigating in 1953 recommended the substitution of a moving three-year average, it does not seem likely that this will be adopted

only to areas with less than average rateable value per head In principle this grant should be very equalizing, it provides virtually similar opportunities for the poorest authorities as the richest enjoy from their own wealth, it will not of course result in equality of rate poundages unless the poorer authorities are restrained in their outlay, but it should result in rate poundages roughly proportional to expenditure

As a result of this Equalization grant, and in conjunction with the transfer of public assistance to central responsibility, in fact a complete equalization of standard of basic services has probably been attained That the new grant has not proved (as many feared) an overpowerful stimulus to expansion is probably because on the one hand its scope is still narrow in relation to other grants, and on the other expansion still gives rise to uncomfortable pressure on the rates in poor areas The principles of this grant have much to recommend them on grounds of simplicity, but it will be seen that for its equity it leans very heavily on standardized valuations Until the valuation problem has been solved many anomalies in its working must necessarily persist

These are difficult problems, and it is not possible here to do much more than indicate their existence, but that at least is necessary, because they are of vital importance for the future The dilemma of central/local relations cannot in any case be avoided, since both the future of democracy and the welfare of the community are at stake, it is worth diligence and patience to discover the right solution

CHAPTER XVI

THE INCIDENCE OF BRITISH TAXATION AND EXPENDITURE

§ 1 **Formal Incidence and Effective Incidence** As we have seen the convenient word "incidence" has been applied to tax problems with a number of different meanings, and this has led to no little confusion There are, however, two meanings which are of particular interest for our present purpose, and concerning these there need be no confusion We have distinguished these as *formal* and *effective* incidence respectively In the present chapter our main business is with the former, it will be as well, however, to recall briefly the basis of the distinction before we proceed

The formal incidence of a tax records the allocation between different income groups of the revenue actually collected during a particular accounting period The formal incidence of income and profit taxes is determined directly from the income groups of the producers of the incomes or the owners of the property (including bondholders), in social accounting terms disposable income=producers' incomes less income taxes The formal incidence of death duties (if we wish to include them in the estimate) is similarly found by taking the gross value of estates passing during the period, relating the properties to the income groups of the former owners, and on this basis dividing the revenue collected

We are not concerned, in formal incidence, to ask what the economic repercussions of these taxes were, whether producers might have worked harder or less hard if income taxes had been different, whether capitalists might have saved more or less had their net dividends been larger, or what steps the elderly may have taken to reduce the value of their estates

before death These questions belong to the field of effective, not of formal incidence

In respect of outlay taxes in similar manner, the task of formal incidence estimation is solely that of determining the income distribution of the revenue actually collected during the accounting period the amount of tax which, aggregated over the year, each smoker (for instance) has paid as a condition of buying his cigarettes The old concept of "shifting" of tax, from the tobacco manufacturer, through various stages to the consumer, is not relevant here because we are not inquiring into the economic repercussions of the tax whether (for instance) if smokers reduce their consumption, manufacturers decide to "bear" part of it themselves, by acquiescing in a reduction of their profit margins, or what the retailers' reactions are if they find an unwanted accumulation of stocks on their shelves These inquiries again belong to the field of effective incidence Although it is highly desirable that empirical investigations into effective incidence should be made, and much too little has yet been attempted in this direction, it is evident that estimates of effective incidence cannot form the basis of unambiguous and precise aggregative statistical estimates, since at bottom they must depend on the particular assumptions on which the analysis is based, and the assumptions appropriate in one time and place may be completely inappropriate for another, so that inter-temporal or inter-local comparisons are misleading

In contrast the method of estimation of formal incidence can be applied at any time or place to give unambiguous results, the accuracy of which will depend only on the accuracy of the primary data on which they are based (such as collections of consumers' budgets) and not on the choice of particular assumptions Having in this way determined the formal incidence (or income distribution) of the revenue tax by tax, we can if we like add the formal incidence of all taxes to obtain the formal incidence of the tax structure on the whole economy In principle we can do the same for public expenditure—or at least for those parts of public expenditure which provide

benefits which are divisible between persons (as collective services such as police and defence are not) and so allocable to different groups [1] If we then confront the two accounts we can discover the formal net effect of public finance on income distribution

It is important to emphasize that any such estimates have only a very limited real content, for economic judgment and policy decisions the important factor is not the formal incidence, but the economic adjustments which are made in consequence of it The sum total of these constitute effective incidence Normally the process of adjustment passes through a number of stages When a tax is paid, command over resources is in the first instance transferred from the private to the public sector, accompanying the payment there will be, in almost all circumstances, a change in income distribution the part of the private sector on which the tax falls, or falls most heavily, will have lost command over resources relative to other parts

The additional resources now available in the public sector may be employed in the purchase of goods and services (which may be either on current or on investment account), or they may be employed abroad Alternatively they may be transferred to other public authorities or back to the private sector, possibly to the same, but more likely to different pockets from whence they came This again will give rise to changes in income distribution

The changes which occur at the various stages in the process will lead to changes in output since they imply changes in demand, these in turn are likely to lead to changes in investment, while the changes in income distribution will tend to alter directly the relation between current spending and saving These are the processes which have to be watched and evaluated by those responsible for keeping an economy running at a high level of activity with an expanding national product, we shall be concerned with problems of this nature in Part III, our present task is much more limited

[1] For a discussion of this point see below, p 264

The question of income distribution and redistribution through public finance early aroused great interest in Britain, far in advance of other countries The first estimates of the income distribution of the tax structure related to the year 1903–04 Interest in the effects of social expenditure were growing throughout the first decade of the present century, as witness such a book as Professor Bowley's "The Division of the Product of Industry" (1911) In the middle 1920s the (Colwyn) Committee on National Debt and Taxation expanded and brought up to date these estimates Later additional information, especially relating to consumers' expenditure, became available, and this facilitated the making of the most detailed estimates of formal incidence which have yet been possible, for the first time also it became possible to include the important local rate in the estimate [1] For the first time also tentative estimates were made of the formal incidence of public expenditure

Since that time the practice of social accounting and of the formulation of a general economic policy based upon it, has greatly improved the relevant statistics, especially in respect of initial income distribution It is thus possible already to improve markedly the accuracy of the income and capital side of the tax estimate While some new information is also available concerning the distribution of consumer expenditure, no such comprehensive data as were used in the 1930's are as yet available for the post-war world An estimate has, however, been made of the formal incidence of taxation and expenditure relating to the year 1948–49 [2] which is some help in bringing the figures up to date, besides being of considerable historical interest, as illustrating the pattern of income redistribution at the height of rationing and progressive taxation (In that year the Special Contribution, based on investment income of the previous year, was levied in addition to the normal income and profit taxes)

[1] Cf F Shirras and L Rostas, *The Burden of British Taxation*, T Barna, *The Redistribution of Income through Public Finance*, and J R and U K Hicks (with C E V Leser), *The Incidence of Local Rates in Great Britain*

[2] Cf A M Cartter, *The Redistribution of Income in Post War Britain*

§ 2 **The Distribution of Income** In virtually all countries income distribution resulting from the production process tends to conform to a similar pattern the vast majority of the citizens have incomes below the average, a small number have incomes substantially above it The British version of this distribution is summarized in Table VII for 1938 and 1953 Now that a number of calculations are available for other countries it is apparent that the degree of inequality shown is not exceptionally great, rather the contrary It may well be that in no other country is the initial distribution of incomes so equal, unless it be one of the Scandinavian countries In the U S A the initial distribution of incomes is also relatively egalitarian, and this is broadly true of all developed industrialized countries It seems to be well established that in poor and underdeveloped countries income distribution tends to be very much more uneven [1] These countries have also much less power of influencing the final distribution of income through public finance than developed countries with well-established tax and social security systems

An attempt has been made in Table VII to allow for the change in the value of money between 1938 and 1953 It is assumed that an income of £500 in the later year would buy a similar bundle of goods as an income of £250 in 1938, this is not strictly true, but it is a convenient approximation In fact, as the result of the Korean inflation, the value of money had fallen rather more than this by 1953, so that all incomes in the later year are in the Table somewhat inflated in relation to 1938 In practice this makes little difference, it seems clear from the composition of each group that we are in fact concerned with the same sort of people in the £500 group in 1953 as those in the £250 group in 1938 and so on

The changes are just what we should expect on general economic grounds The numbers in the top group have fallen relatively (and slightly in absolute terms also, especially if we

[1] Cf "The Distribution of Income in Ceylon, Puerto Rico, the United States and the United Kingdom", by T Morgan, *Economic Journal*, Dec 1953

remember the overvaluation of 1953 incomes just mentioned) The numbers in the third group have expanded considerably and in the other two slightly The fall in the number of upper incomes can easily be explained, mainly by the smaller distribution of dividends and by the cumulative effect of death duties The expansion of the lower reflects the better employment position The lowest group of all includes of course many part-time workers, and the extension of employment among women is one of the factors accounting for its expansion

TABLE VII THE DISTRIBUTION OF PERSONAL INCOMES IN 1938 AND 1953

Income Class (£)		Numbers in Class (th)		Average Income before Income Taxes (£)	
1938	1953	1938	1953	1938	1953
Over 1,000	Over 2,000	289	285	2,667	4,000
500–1,000	1,000–2,000	539	790	669	1,322
250–500	500–1,000	1,890	6,575	334	652
Under 250	Under 500	15,300*	17,650	169	283

* Unofficial Estimate

Thus, over the period there has been a general evening up of the initial distribution of incomes, other factors outside the public finance system have also contributed to a greater equalization of spending power In particular rent control benefits the lower income ranges more than the upper, because a larger proportion of them live in rent-controlled houses Table VIII shows the difference which income and surtax made to this initial distribution of incomes It will be seen that in 1938 the top group parted with 30 per cent of their incomes in income and surtax, the second group also made a substantial contribution of over 11 per cent, but the contribution of the two lower groups was very small By 1953 the situation had

altered materially the top group, besides being smaller and less well off, now parted with 66 per cent on the average (individually of course with much more, since this group covers the progressive range of surtax), the second group now parted with 20 per cent, while the third group lost 8 per cent, due to the extension of income tax down the income scale In the lowest group, although the total contribution was still small, it had greatly expanded

True disposable income depends also on the money grants (or income transfers) made through the social services and similar provisions In 1938, due to the great importance of unemployment pay and public assistance, all but a negligible

TABLE VIII THE FORMAL INCIDENCE OF INCOME TAXES

Income Class (£)		Average Income After Taxes (£)		Percentage taken in Taxes	
1938	1953	1938	1953	1938	1953
Over 1,000	Over 2,000	1,823	2,104	30 1	66 0
500–1,000	1,000–2,000	597	1,069	11 4	20 6
250–500	500–1,000	323	606	3 2	8 0
Under 250	Under 500	169	276	0 2	2 5

percentage of these transfers accrued to the lowest income group In the later year, due to the fall in unemployment, the relative importance of money transfers had fallen, but they still mainly accrued to the lowest income group [1] On the basis of the 1948 estimates it seems that virtually the whole of pensions, 87 per cent of family allowances and 89 per cent of other transfers, including educational grants, accrued to the "under £500s" in that year, the percentage addition to their disposable income was 11 per cent, while the next group received a contribution of 1 per cent only It does not seem likely that these relations can have altered much by 1953

[1] For further discussion of this point, see below p 264

The other important redistributional tax is of course death duties, in recent years the redistributional element in this has considerably increased, the progression has been steepened and the exemption limit raised, thus cutting out a large number of small estates. Death duties were, as we have seen, the first progressive taxes to be introduced, but for many years their rates remained moderate and the effect on income distribution was negligible. They gradually crept up, and in 1930 were drastically increased. Already by 1938 the largest estates paid 50 per cent, but an estate of £200,000 still paid the comparatively moderate tax of 25 per cent. The present rates, progressive up to 80 per cent on the whole estate, were established only in 1949, so that sufficient time has not elapsed for their effect on incomes to have worked out (for this reason the 1948 estimates understate the position in 1953). These confiscatory rates not only break up estates directly, but lead indirectly to greater equalization of incomes through gifts *inter vivos* and trusts. They also tend to capital consumption and abstention from saving, this gives rise to further equalization, although probably at the cost of some productivity. Finally the inflationary price rise has substantially increased the burden of death duties. An estate of £200,000 in 1953 had a real value of between £75,000 and £100,000 in 1938, and on this basis the rate of tax had risen by more than 40 per cent.

§ 3 **The Formal Incidence of Outlay Taxes**. The formal incidence of outlay taxes can only be discovered by asking people how much of the different taxed commodities and services they purchased over a given period, usually a week, and when samples of several weeks have been taken, expressing these as yearly rates. Finally the total revenue collected during the year in respect of the different taxes must be allocated to different income groups on the basis of this information. The family budget method is full of difficulties and the results inevitably contain a good deal of guesswork, they cannot be regarded as being on all fours with estimates of the

income distribution of income taxes This by no means detracts from the importance of attempting to make the estimates

The first difficulty is that the tax "unit" differs as between the two types of tax The income tax family consists formally of the single person or married couple, although information is gradually improving which enables dependent children to be allocated to the standard of living which they actually enjoy For most outlay taxes in contrast the tax family consists of those who pool their expenditure for food, furniture, rent and perhaps clothes For the all-important taxes on drink and tobacco on the other hand the unit is strictly individual, and here in particular the family budget method tends to break down completely Information is obtained from housewives, they rarely know either the whole income of the family or the consumption of drink and tobacco by the several members Even if the chief smokers and drinkers can be contacted they are unlikely to own up to the extent of their indulgence It has been found that there is always a serious difference between the consumption implied by the revenue collected and the consumption admitted by taxpayers

There is a further difficulty in respect of intermittent purchases, such as clothes and furnishings, which are seldom correctly recorded by the weekly method This was unimportant in 1937 since few of them were taxed, but the advent of the purchase tax has altered the situation Partly for the reason that so much larger a percentage of their expenditure consists of intermittent purchases of this nature, the budget inquiry method works even less well in the middle-class range

Finally there is the problem of the local rate This differs from every other British tax in that the incidence varies markedly—before the advent of the Equalization Grant it differed very markedly indeed—from area to area In a federation of course such interlocal variation is a feature of a number of taxes, especially sales taxes, for this reason it is very difficult to obtain meaningful and inclusive estimates of

formal incidence in federal countries Only very exceptional inquiries provide sufficient information for making separate area estimates of rate incidence, normally budget studies throw up only a single figure of gross rents (rents plus rates) which are useless for the purpose Fortuitous circumstances—the coincidence of two inquiries—produced the necessary information for 1937 but it may not again be available for many years While this is regrettable the greater equalization of rate incidence, due to the greater equalization of poundages on the one hand and to larger incomes in the formerly highly rated areas, together with the decline in the importance of rates in relation to other outlay taxes, makes the problem of estimating the formal incidence of rates of somewhat less importance than formerly [1]

The investigations of 1937 pointed pretty clearly to a pattern of incidence by which outlay taxes fell neatly into three groups (i) the vast majority falling on mass consumption, including taxes on essential foods (tea, sugar), drink and tobacco, and local rates, (ii) a group of taxes on not quite so common consumption, including duties on silk and rayon, cameras and so on, the motoring taxes (fuel and licence duties) and taxes on the less essential and luxury foods, (iii) a substantial revenue derived from taxes falling indirectly on consumption through the production and marketing processes, such as local rates on business premises and motoring taxes on lorries, buses and delivery vans

In the first group in 1937 over 90 per cent of the revenue was derived from the (prewar) "under £500s", and something over 80 per cent from the "under £250s" In the second group incidence was more evenly divided between the under and over £500s—in respect of silk and rayon it seems to have been divided about 50/50, in the case of motoring taxes as much as 70 per cent may have come from the over £500s It is not possible to determine the incidence of the third group with any precision, it no doubt lay between that of the first and second, probably nearer to that of the first

[1] For further discussion of this point see below, p 263

As we have seen the 1948 estimates are not based on fully independent data, it is interesting nevertheless to compare the picture which they reveal with the pre-war situation Those two stalwarts, taxes on drink and tobacco, continue to show 80 per cent of the revenue as derived from our lowest group (under £500 in post-war conditions) It must always be remembered, however, that 80 per cent of the population is to be found in this group Apparently a rather smaller percentage of the revenue than in pre-war conditions was derived from the next group up the income scale This perhaps reflects the well substantiated decline in smoking among young men in the middle income groups The food taxes had by 1948 largely faded out through being assessed at unit and not at *ad valorem* rates [1], indeed many had been replaced by subsidies The incidence of these we must examine later Both the new Betting tax and the much increased Entertainments duty showed a somewhat less regressive incidence, for entertainments 50 per cent of the revenue was derived from the under £1,000s and 72 per cent from the under £500s, for betting the figures were respectively 69 per cent and 77 per cent

The 1948 incidence of motoring taxes is of historical interest only, due to the inavailability of cars and to the persistence of petrol rationing The result of these factors was to reduce the percentage derived from the higher income groups (over £1,000) to a mere 18 per cent in place of the pre-war 70 per cent Considerable interest attaches to the incidence of purchase tax for which there was no pre-war parallel The greater part of the revenue has been derived from three sources clothing, durable consumers' goods and a variety of fancy articles, including cosmetics, taxed at rather high rates For none of these was the incidence highly regressive, due on the one hand to the exemption of utility goods from tax and on the other to the *ad valorem* rates of tax The average incidence of the tax as a whole shows 53 per cent derived from the over

[1] Consequently as prices rose their effect gradually declined, this would have occurred also in respect of the taxes on drink and tobacco had their rates not been repeatedly raised See also Chart 1, p 68, above

£1,000s and 38 per cent from the over £500s This significant movement towards the reduction of the regression of outlay taxes was thus on the average less than the increase in regression due to the great increase in the taxes on smoking with their highly regressive incidence [1] As we shall see, however, there is an important qualification which needs to be made here

Returning to the firmer figures of 1937 the situation was that while over 90 per cent of the revenue from income taxes and death duties came from the over £500s (in pre-war conditions), 90 per cent of the revenue from outlay taxes was derived from the under £500s There was thus a quite different income distribution for the two sorts of taxes a persistently progressive incidence of income and capital taxes and, on the whole, an almost equally persistent regressive incidence of outlay taxes When combined the tax structure showed a progressive incidence ranging from 17 per cent on the very low income of £100 to over 90 per cent on an income of £100,000 This is illustrated in Chart 3 The waviness of the income tax curve is the reflection merely of the proportionality for short ranges which results from the reduced and standard rate "bands" [2]

It appears that the lower end of the outlay tax curve was slightly regressive, presumably because the variety of expenditure was narrower in the lowest income group, many of these would be young earners and single individuals From this point the curve assumed an almost proportional course up to about £500 when it began to drop sharply There are several possible explanations of this range of relative proportionality In the first place, in the pre-war situation the consumption of certain common articles (such as tea and sugar, apart from that used in confectionery) appears to have expanded parallel with rising income up to a point of about £500 when it became stabilized, so that tax as a percentage of income dropped

[1] Presumably the substitution of the less regressive "D" scheme operating in 1953 must still further have reduced the regression of purchase tax as compared with the operation of the utility scheme in 1948

[2] See above, p 185

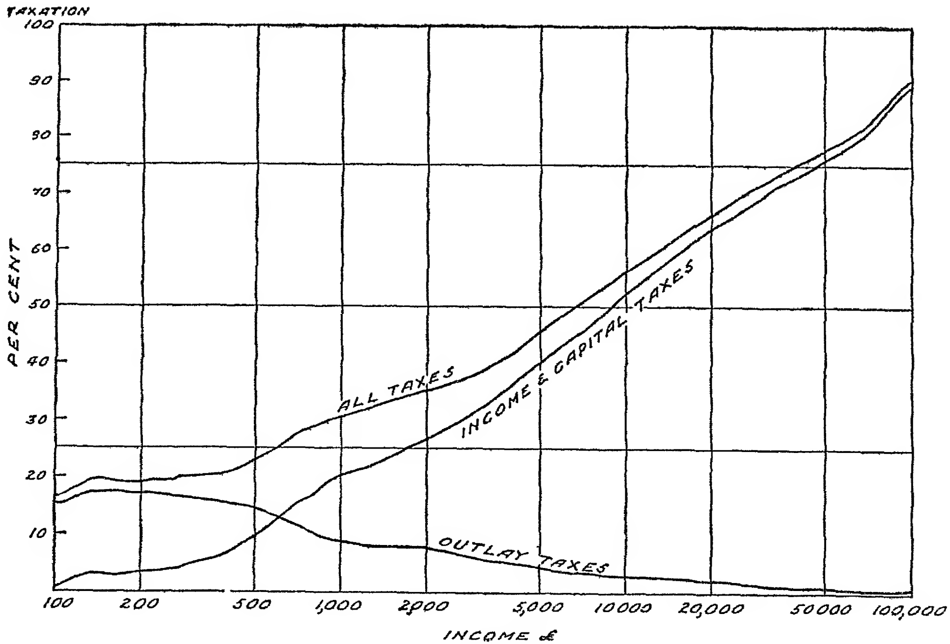

CHART 3 TAXATION AS A PERCENTAGE OF INCOME, UNITED KINGDOM, 1937

sharply More important, because the revenue is so much larger, in the relatively free market conditions of 1937 expenditure on house room, and hence rate payments, tended to expand fairly regularly with income As income rises, and no doubt as the size of the family increases, people tend to move into bigger houses, thus leaving rates as a percentage of income as high as (or even a little higher than) before There was some indication in the 1937 data that proportional ranges of rate incidence were repeated higher up the income scale

The figures on which the curves are based are averages for the whole economy In respect of most taxes deviations from average consumption within each income group are not large, but this is not so in respect of the consumption of drink and tobacco The result is that for non-smoking or drinking families the regression of outlay taxes is very much smaller than appears from the average [1]

In respect of the local rate also deviations from the average incidence are very important, between one part of the country and another In conditions of the 1930s the country was divided very clearly into three rate zones high poundages in Wales, middling poundages in the North, including Lancashire and Yorkshire, and low in the Midlands and South Over the average of weekly wage-earning income groups rates were, in 1937, 4 per cent, 3 5 per cent and 2 9 per cent of family expenditure respectively, in the three zones Cutting across this regional distinction was another, depending on the size of the community broadly speaking the larger the town the higher the rates, a difference which was only partly compensated by a higher level of incomes in the large cities Thus the average rate incidence in London on these income groups was just as high as in Wales, in three out of the four largest cities it was higher still At the other extreme in every part of the country rural rate incidence was lower than urban, in spite of the relatively low income of farm workers Generally

[1] This point was first investigated by D Caradog Jones, *Journal of the Royal Statistical Society* 1927, cf also U K Hicks, *The Finance of British Government*, p 275

speaking, however, higher urban rates implied a higher standard of local services, consumers were, so to speak, buying more of the product, and for the most part this probably suited them

The income distribution of the 1937 tax structure differed markedly from that of earlier calculations [1] In 1903–04 the whole curve was proportional or even slightly regressive from £1,000, by 1913–14 the progressive head had begun to rear up, following the introduction of supertax, but the highest combined incidence was less than 10 per cent of income The cost of the first world war brought the high point to just over 50 per cent, during the 1920s it ran at about 44 per cent, rising again in the early 'thirties to over 50 per cent, in a conscientious but largely mistaken endeavour to balance the budget in depression In the meantime through the 1920s the regressive "tail" had been rising, to something over 10 per cent (if rates had been included it would have been more like 17 per cent), leaving a decided "dip" at about the £500 level, where total incidence fell to only some 6 per cent

As can easily be seen from Chart 3, this dip was due to the declining effect of outlay taxes as income increased, while income tax was still negligible in the lower ranges In so far as the dip was not a statistical illusion it may well have been economically beneficial, taxing relatively lightly a stratum of the population which is particularly important from the point of view of productivity There is no doubt, however, that current calculations exaggerated the importance of the dip, partly through the omission of the local rate, with its more proportional incidence in this range, partly through the assumption of an even distribution of the incidence of taxes on smoking and drinking within each income group As will be seen from the Chart, with the lowering of the income tax exemption limit and the inclusion of the local rate the dip had in any case virtually disappeared by 1937

Unfortunately we do not have sufficient information to

[1] For a description of earlier calculations cf U K Hicks, *The Finance of British Government, 1920–36, cit*, p 270

redraw the curves for the 1953 situation, but there are several things we can say about their course with reasonable assurance In the first place, owing to the additional pressure on the revenue, due to the cost of the second world war, the continuing necessity for defence expenditure and not least the expansion of welfare expenditure, both curves have shifted up substantially A maximum incidence of outlay taxes of 17 per cent before the war would now read about 24 per cent, in 1948 income taxes as a percentage of personal incomes had reached 73 per cent on all incomes above £20,000, by 1953, as we have seen, they averaged 66 per cent from £2,000

Secondly it seems probable that the "dip" at the crossing of the two curves has finally disappeared, due to the greater coverage of income tax (mainly the result of inflation) and to the presence of purchase tax with its relatively mild regression The local rate has not only declined in relative importance, but its incidence has become more even between one area and another, both through the operation of the equalization grant and through the rise in employment and incomes in the formerly most highly rated areas Rate incidence in London may well now be considerably higher than in Wales Broadly speaking, the combined effect of the increase in the taxes on drink and tobacco, of the purchase tax and of the decline in the importance of food taxes and of local rates, has been to shift incidence from the family to the single individual The same tendency has been at work in income tax through the increased rebates for children and other dependants, it has of course been further reinforced by means of direct family allowances for the second and succeeding children

§ 4 The Incidence of Divisible Expenditure and the Redistribution of Income We have still to consider the income distribution of public expenditure, other than money grants to persons (income transfers), which we have already set against income taxes First, however, we must note a logical difficulty which does not occur on the tax side If we want to make a nice tidy balance sheet of the redistribution of income through

public finance we ought somehow to distribute the whole of public expenditure on revenue account between the different income groups, as has been done on the tax side But while most taxation[1] is an individual or family affair, about one half of public expenditure goes to provide benefits which are to all intents and purposes indivisible How are we to impute the benefits of defence, justice, police and roads, or even the ordinary expenses of administration, between people in different economic circumstances? Clearly there is no rational way of doing so, some writers have given their readers a choice of a number of methods, but none of them has any logical precedence over the others It seems better to be satisfied with distributing only the expenditure which is divisible, in the sense that the benefits can be ascribed to particular groups Even so we are up against a much more difficult problem than on the tax side, since the information concerning the "consumption" of divisible benefits is less good than the information concerning the purchase of taxed commodities

Divisible expenditure other than money grants takes two different forms (i) the provision of goods and services, for instance through the system of public education, the national health service, or the houses provided by local authorities, and (ii) rights to the consumption of certain goods and services below cost, such as subsidized foods These latter can be regarded as "outlay transfers", exactly parallel to outlay taxes in reverse According to the 1937 calculations, while income transfers were progressive with needs (formed a higher percentage of income as we moved down the income scale), this was not true of benefits conferred by the social services or by outlay transfers, so far as the lowest income groups were concerned, although over the whole income range all social expenditure was of course progressive with needs

Table IX shows the income distribution of the main divisible expenditures among the three lowest income groups

[1] Some difficulty arises over taxes on undistributed profits, which are usually imputed to the owners of the property although not forming part of disposable income

in 1937, in *per capita* amounts It will be seen that in each case the not so poor benefited more than the very poor It was a well-known fact that in the inter-war period house building by local authorities mainly benefited the better-off wage earners [1] In the 1937 situation income transfers accounted for 50 per cent of social expenditure, provision of goods and services for 43 per cent and outlay transfers a mere 7 per cent It is possible that these last (school meals, cheap milk and so on) were also progressive with needs, but if so they would have been less sharply so than income transfers

TABLE IX THE INCIDENCE OF DIVISIBLE EXPENDITURE 1937–38

(Other than Grants to Persons)
(£s per an per cap)

Income Class	Education	Health	Housing
Under £125	2 1	1 2	0 4
£125 but under £250	3 1	1 2	0 7
£250 but under £500	3 7	1 3	—

In the post-war world the relative importance of the different types of divisible expenditure has altered considerably In the full employment economy the decline in assistance and unemployment benefit implies that income transfers are less important and less progressive with needs than they used to be, on the other hand, with the food subsidies there has been a great increase in outlay transfers Table X shows a parallel estimate to that of Table IX for 1948 It will be seen that—strangely enough—housing was the only one of the four services which was progressive with needs through the three income groups In the case of education, while the £250 to

[1] Or to put it another way, the chance of a family in the lowest income group getting a council house was only 60% of the chance of a family in the next group, the chances were better for the upper half of this group than for the lower, cf Barna, *op cit*, and M E A Bowley, *Housing and the State*

£500 group received nearly twice as much per head as the groups below them (no doubt due to their taking greater advantage of secondary education services) the third group still received a greater benefit than the lowest group

Both the health service and the food subsidies were apparently *regressive* with needs throughout this range In the case of the former this may have been due to ignorance of the services available, or to a reluctance to seek advice, in the case of the latter it was no doubt due to inability to take up the whole of the ration This illustrates the wastefulness of general food subsidies as a method of income redistribution, they confer their benefits indiscriminately on those who do and

TABLE X THE INCIDENCE OF DIVISIBLE EXPENDITURE 1948–49

(Other than Grants to Persons)
(£s per an per cap)

Income Class	Education	Health	Housing	Food Subsidies
Under £250	5 2	8 5	3 8	14 7
£250 but under £500	10 7	13 3	2 9	22 8
£500 but under £1,000	8 8	14 1	neg	25 4

those who do not need them On the other hand in one sense the food subsidies did benefit the very poor more than others Since food occupies a larger place in their family budgets than in those of the better off, the percentage of income set free by receiving their food below cost was correspondingly larger In 1948 the general food subsidies (excluding the welfare foods) were at their maximum of £390 millions, by 1953 they had declined to just under £200 millions The cost of the health service, however, continued to expand, in 1948 (before it had fully got into its stride) it cost £240 millions, by 1953 it had climbed to just under £500 millions, and was thus substantially the largest item in divisible benefits Thus, by and large, over the field of divisible benefits (other than money transfers), the

pre-war pattern persisted, with the very poor tending to benefit less than the not so poor

If we now attempt to put together the results of taxation and social expenditure we can get in a formal sense an estimate of the redistribution of income through public finance An estimate of this has been made for 1948 on a base comparable to the estimates of 1937, and is quoted in Table XI It will be seen that the lowest income group received a smaller net addition to production incomes (personal factor incomes) in

TABLE XI * THE REDISTRIBUTION OF INCOME IN 1937–38 AND 1948–49

Income Class (£ th)		Numbers (mns)		Redistribution (per cap £s)		Disposable Income as % Personal Factor Incomes	
1937	1948	1937	1953	1937	1953	1938	1953
< 125	< 25	21 8	20 5	+12 6	+39 0	117 4	112 2
125– 25	25– 5	18 8	20 8	+5 4	+22 2	101 1	96 8
25– 5	5–1	4 8	5 6	+2 2	−24 9	96 9	85 6
5–1	1–2	1 2	1 4	−33 0	−142 5	85 5	76 0
1–2	2–5	0 5	0 5	−115 0	−735 0	76 0	64 7
2–5	5–20	0 3	0 1	−565 0	−4380 0	59 7	42 5
>10	>20		005	−7375 0	−37450 0	27 1	17 3

* From Cartter *The Redistribution of Income in Post War Britain*

the later year than in the earlier, but that relatively the larger incomes lost substantially more

The main factor at work in the change has of course been the greater weight of taxation over the whole structure, due partly to the war and its aftermath, including persisting defence expenditure, but mainly to the social expenditure programme itself A programme of this magnitude must necessarily be financed to a considerable extent by the income groups who benefit from it Within their ranks, however, a simultaneous process of lateral redistribution is continually taking place

from the healthy to the sick, from those of working age to the elderly and from the single and childless to the parents of young families Thus estimates of redistribution by income omit a most important aspect of the phenomenon Nevertheless it will be remarked that in spite of the great increase in non-divisible expenditure the difference between the additions to the lower incomes and the subtractions from the higher were greater in 1948 than in 1937 In this sense the pace of redistribution had quickened It must again be emphasized that the results of income redistribution thus obtained are formal, illustrating only the position at the moment of paying taxes or receiving benefits, and can tell us nothing directly about the economic process whereby these phenomena percolate through the economy They do, however, render the task of tracing effective incidence easier by pointing the direction where inquiries should start

PART III

PUBLIC FINANCE IN THE NATIONAL ECONOMY

CHAPTER XVII

PUBLIC FINANCE AND THE LEVEL OF ACTIVITY

§ 1 **Public Finance and Fiscal Policy** The last chapter introduced us to one aspect of the effects of public finance as a whole We must now turn from distributional considerations to productional effects The two of course are not unrelated since the pattern of consumption, and to a considerable extent also the type and volume of investment, are largely determined by the distribution of disposable incomes

Fiscal policy is concerned with the manner in which all the different elements of public finance, while still primarily concerned with carrying out their own duties (as the first duty of a tax is to raise revenue), may collectively be geared to forward the aims of economic policy These we may define as stability at a high level of employment on the one hand, and on the other the steady increase of productivity so as to obtain the maximum growth from the available resources

In discussing fiscal policy we thus need to consider all types of public outgoings and incomings on the one hand expenditure on current goods and services, loans, transfers, fixed capital formation and purchase of stocks, on the other, tax revenue and public income from property, borrowing and debt management It is important for fiscal policy that all these elements should be kept in proper relation to each other Indeed balance is the heart of fiscal policy, above all the

relation of current outlay and true revenue items in the Budget, since this denotes (as we shall see later) the contribution of the government to the saving or dissaving of the economy It is this magnitude which needs to be adjusted in order to balance the nation's economic budget This is a much more fundamental account than the Chancellor's budget

Now that fiscal policy has been developed as an established economic function of government, every country is anxious to gear its public finances in pursuit of the twin aims of stability and growth, but their relative importance is very differently regarded from one country to another A poor and backward country will strive to put most of the emphasis on growth, especially if, as may well be the case, its population is expanding rapidly Nevertheless it cannot afford to neglect stability considerations The process of development has an inherently inflationary bias in that additional incomes are distributed to those engaged on the new works, without there being, to start with, any additional consumers' goods to satisfy the new demand Hence such a country will be wise to season its expansion with stiff taxes and other contractionary public finance measures, if it is to escape balance of payments difficulties and even a danger of an unmanageable inflation

On the other hand a country whose natural resources have already been developed to a high degree, and especially one whose population is not expanding rapidly (so that the changes in tastes and techniques which inevitably occur cannot easily be absorbed in a tide of rising demand), will tend to concentrate on stability, on keeping its already developed resources fully employed At the same time if it neglects the means of growth —a sufficient allocation of resources to new investment, including research into new processes—there may be a danger that it will subside into the sort of stagnation that seemed to have overtaken most of the developed countries in the 1930s

In the present chapter we shall be primarily concerned with fiscal policy to secure stability, in the following we must consider briefly fiscal means to promote growth The two

aspects are, however, inextricably linked. A steady rate of expansion will tend to reduce the violence of such fluctuations as occur; a successful full employment policy will provide an atmosphere which is congenial for growth.

The idea that public authorities should have some responsibility for economic stability is by no means new in England, although it was not formally acknowledged until 1944. Enterprising Governors of the Bank of England realized from early in the nineteenth century that the Bank's credit policy could contribute, far from negligibly, to stability, by lopping off the tops of speculative booms by credit restriction and by filling up depression troughs by an easy money policy, notwithstanding that the Bank's primary duty was concerned with international rather than with internal stability. The part that public expenditure could play in promoting growth was (as we have seen) emphasized by Adam Smith and his contemporaries when England was just setting forth on the path of development, and when she was consequently in urgent need of just those economic and social "overheads" (such as roads and schools) which are the prime need of developing countries to-day.

At a later stage in the nineteenth century, when these overheads had been provided and growth seemed to be sufficiently assured by unaided private enterprise, the emphasis in British policy shifted to the attempt to remove the fiscal obstacles to growth. In particular, much thought and discussion was devoted to ways and means of exempting saving from income tax. As time went on and the rapidly expanding stage of the British economy passed away, this somewhat negative fiscal policy became economically inappropriate, while on the other hand the growth in wealth and social consciousness made it increasingly unacceptable on distributional grounds.

A necessary prerequisite for the correct orientation of a policy of economic stability, or compensatory finance, in modern conditions was an adequate economic analysis of the real (as distinct from the monetary) forces underlying industrial fluctuations. The first steps in providing this analysis in Britain were taken (most notably by Professors Pigou and

Robertson[1]) in the years just preceding the first world war. It seems to have been the crisis of 1907 which first aroused interest in this direction. Still greater stimulus to thought was provided by the prolonged under-employment of the 1920s and the chronic unemployment of the 1930s, which appeared to contemporaries no less a depression than the famous bad years of 1870–90. It is to the 'twenties and 'thirties that we owe the fundamental theory of compensatory finance.

Outside Britain the most interesting development in the analysis of fiscal policy was in Sweden, where a group of young economists (especially E. Lindahl and G. Myrdal[2]) brought up in the general or macro-economic approach by their teacher, Knut Wicksell, were groping for a comprehensive and rational policy of compensatory finance. The Swedish contribution was notable for emphasizing from an early stage three points which later experience has shown to be vital: (i) the importance of establishing machinery to ensure that in future depressions public authorities would not act "perversely", by taxing more and spending less, as they had done in the past, and would be likely to continue to do unless special measures were taken; (ii) the importance of the formation of additional assets in the public sector, both as a means of promoting growth in the economy and for their steadying effect; (iii) the need to gear the system of public accounting and the arrangement of the budget so as to make it appropriate for the additional responsibilities of fiscal policy.[3]

Meanwhile in Britain the economic analysis of fluctuations was making steady progress. The first important landmark in the new approach was Keynes's *Treatise on Money* (written in the late 1920s). This drew attention to the cyclical importance

[1] Pigou's *Wealth and Welfare* (the forerunner of *The Economics of Welfare*) was published in 1912; D. H. Robertson's *Industrial Fluctuations* in 1915.

[2] Lindahl's *Penningspolitikens medel* was published in 1929, Myrdal's *Economic Effects of Public Finance* (also in Swedish) in 1934; credit must also be given to the Swedish government, whose Royal Commission on Unemployment was the direct cause of the Swedish studies of the 1930s.

[3] For the significance of this see below, pp. 339ff.

of the relation between saving and investment, especially the propensity of both private and business capitalists in depression to fail to sustain the level of incomes in the economy by increasing their cash balances instead of spending or investing as usual At this stage of analysis, however, the propensity to spend or save, and hence the level of incomes, was related primarily to the rate of interest Policy was thus directed to the monetary rather than to the fiscal instrument By saturating the desire for liquidity through an easy money policy it was confidently hoped that recovery would be brought about This approach was characteristic also of Swedish contemporary thinking

The direct contribution which public expenditure could make to recovery was first explicitly expounded by R F Kahn in the summer of 1931 [1] The idea that public expenditure should be used in depression as a palliative to unemployment was of course not new, relief works have been used from time immemorial, but on humanitarian and moral rather than on economic grounds The Victorian attitude to such works, enshrined in what was known as the "Treasury View", was that public works could have no beneficial economic effect Either the works produced would be economically useless or they would merely represent an anticipation of what would have been done later in any case The new approach, however, demonstrated that the additional incomes distributed on the works in a given period would not merely serve to sustain demand, but would have "Multiplier" effects, depending in volume on the degree of "leakage" out of the new incomes through expenditure on imports or through saving Moreover this favourable effect would be quite independent of what might happen when the completed works came into use

§ 2 **The Principles of Compensatory Finance** The next stage in theoretical development completed in principle the analytical foundation on which modern fiscal policy is based This was marked by the publication of Keynes's *General Theory of*

[1] In the *Economic Journal*, "The Relation of Home Investment to Unemployment"

Employment at the end of 1935 The analysis was fundamentally a further development of that of the Treatise and the Multiplier, but it differed significantly from the former in relating the level of activity to the level of effective demand and saving to the level of income, rather than to the rate of interest This shift in emphasis had two implications for policy In the first place the operative factors were shown to be those which were directly amenable to fiscal policy rather than to credit control, this was not to deny that low interest rates might be advantageous, on distributional and budgetary grounds, if less certainly always on economic grounds In the second place it became clear that the responsibilities of fiscal policy must extend beyond the bounds of a self-regarding policy for the public sector (such as would be implied in the avoidance of "fiscal perversity") to the correct alignment of the level of money incomes in the whole economy

The preoccupations of the 1930s were wholly with the problems of under-employment, due to the generation of insufficient incomes to ensure full capacity usage of factors In these circumstances no particular precision in public policy was called for The greatest expansion that could in practice be brought about was unlikely to run into any international difficulties or shortage of supplies once the gold standard had been abandoned In fact, at this stage the technical obstacles to "reflation" were formidable, and no great success was achieved by fiscal policy in the 1930s by any country There was, however, a growing understanding and acceptance both of the principles and of the means of compensatory finance

In depression, it was realized, in addition to an easy money policy (which would promote growth as well as recovery), there must be a fiscal policy of refraining from increasing tax rates merely for the purpose of achieving a balanced budget, accompanied by a definite programme of expenditure This programme could, of course, be financed out of taxation, but it was convincingly demonstrated[1] that it would be more

[1] Cf the "models" set out by N Kaldor in Appendix C to Lord Beveridge's *Full Employment in a Free Society*

effective to pay for it by borrowing, since the taxes would have a contractionary effect which would itself need to be compensated

This position was, however, by no means universally accepted The Coalition White Paper on Unemployment of 1944, which set the seal on the official acknowledgment of responsibility for fiscal policy, carefully refrained from stating that deficit finance in the general budget might be required, although it was prepared to allow one on the budget of the Unemployment Insurance Fund Another school of thought considered that a specific expenditure programme was unnecessary, it would be sufficient to allow a deficit to develop spontaneously by refraining from raising tax rates There would seem to be no good reason, however, why advantage of both sides of the budget should not be taken in gearing fiscal policy for recovery

Even more than the Treatise, the General Theory was born of depression, superficially from the policy point of view the main difference between the two was the increased emphasis now put on fiscal rather than on monetary policy In fact, however, the way had been opened for a more fruitful approach, which would make it possible to determine in principle not merely the right direction for policy, but also the correct quantitative degree of government action that would be required to maintain full employment at stable prices The mechanism for this[1] lay in confronting an estimate of the total resources available with an estimate of the probable demands upon them for consumption and investment, in the public and private sectors taken together The estimates were to be based on calculations of the national income, arranged as an integrated system of accounts, in the sense that an alteration in one figure could not take place without requiring a corresponding adjustment somewhere else

The difference, if any, between the two estimates thus confronted constituted a "gap" which required to be filled by

[1] As explained most clearly in Keynes's "Britain's Income and Economic Potential", *Economic Journal*, December 1939

public policy either by direct action or by such indirect action as would cause the private sector to take the necessary steps to fill it spontaneously It was especially important (although this was not noticed until Keynes himself pointed it out in the article just referred to) that the "gap" might run in either direction too little demand or too much demand in relation to available resources The new method of determining the correct amount of government action was thus of general application, either to deflationary or inflationary conditions

The simple aggregative approach on which the first "scientific" compensatory finance was based served well enough in war-time, when economies, especially the British economy, were exceptionally amenable to direct controls as a support for fiscal policy In more complicated situations it has been found to be over crude and static as a reliable basis for policy direction In order to forecast with any degree of accuracy the movement of economic factors it is necessary to break down the aggregates into the budgets of their component sectors broadly speaking consumers, households, firms,[1] public authorities, and the outside world The more subsectors these in turn can be broken down into, the easier it becomes to see the machine working as the wheels go round, and so to foretell its course

In recent years, notably from 1952[2] in Britain, remarkable progress has been made in this sort of "Social Accounting", as it has come to be called We shall have to discuss it further at a later stage The technique of the process is by no means yet fully established and the statistics behind fiscal policy may be expected to improve year by year The essential revolution has, however, taken place, well-founded quantitative estimates increasingly take the place of unreliable hunches Once the right statistical questions are asked, sooner or later the statistical answers to them can be made available, and thus

[1] It is convenient also to distinguish separately firms that are public corporations

[2] Signalized by the publication in that year of the first of the annual "Blue Books", greatly expanding the information hitherto available in the White Papers on National Income and Expenditure

the way is opened for an ever-increasing knowledge of the working of the economic system The system of social accounting is not tied to any particular form of policy, in itself it has no policy implications It is merely a means to a better performance of whatever type of policy a country desires, and it is powerless unless appropriate and flexible means of policy implementation are also available To these we must now turn

§ 3 The Means of Compensatory Finance Attack from the Revenue Side When discussing the instruments of compensatory finance it is useful to distinguish at the outset between automatic stabilizers, which are "built in" to the system of public finance, so that in the course of their ordinary operation they have a counter-cyclical effect, and those which have to be applied as a result of a policy decision The first have two advantages that they come into operation immediately in the manner of a thermostat, and secondly that they call for no decision, the necessity for which is in itself an acknowledgment that something is wrong and which consequently may have an adverse effect on confidence The most obvious of these automatic stabilizers is the unemployment insurance system, including public assistance Funds are regularly accumulated in times of good employment and decumulated in depression Another, which is not so easily recognized as such, is the practice of reckoning the depreciation on fixed assets and stocks for tax purposes on the original cost of the equipment or of the longest held stocks respectively In times of rising prices this practice results in taxing more than true profits while as prices fall tax liability is less than true profits

The trouble about these automatic stabilizers is that their effect is weak relatively to what might be accomplished by a major policy decision Very often, however, their effect can be strengthened in a manner which calls for hardly any action Thus the rates of social insurance contribution can be raised in time of boom, and lowered in times of slump, or even, as has been more than once suggested, substituted by a *per capita*

subsidy on the employment of labour A counter-cyclical movement of this type was written into the Unemployment Insurance system by the Unemployment Act of 1934, under which the Statutory Committee responsible for rates of contribution and benefit was directed to balance its budget only over the course of a complete cycle This provision was dropped when the insurance funds were amalgamated in 1948, it must be acknowledged that the notion of a budget balance over a cycle (originally a Swedish idea[1]) is not very practicable since it presupposes a degree of regularity which few cycles exhibit The use of an anti-cyclical device of this type was also strongly advocated by the 1944 Report With the inclusion of the whole nation in the insurance system it could now be a much more powerful instrument than it would have been in the 1930s

In a similar way the terms on which depreciation allowances are given can be varied according to the state of activity The institution of "initial allowances"[2] whereby a large proportion of the cost can be written off in the first year of the life of an asset, instead of at a constant rate over its whole life provides a very simple way of doing this A quick write-off of the major part of the total cost of a fixed asset (at one time 40 per cent was allowed in the first year), stimulates investment both by reducing vulnerability to changes in prices and economic outlook during the life of the asset, and by postponing liability to tax, if a succession of investments is being undertaken Variations of this device can also be used as a longer-term stimulus to investment (see below, p 305) On the other side, experience in 1952, when initial allowances were temporarily withdrawn and private investment was substantially cut back, suggests that the device is even more useful as a boom than a depression stabilizer[3]

When we turn to more powerful measures which can be

[1] As part of the Budgetary Reform of 1938

[2] First in 1945, see above, p 196

[3] The impact effect of the announcement of the withdrawal of the allowances was, not unnaturally, to accelerate investment

taken deliberately it will often be found that one will be more useful for fighting an inflation, another for promoting recovery On the whole it must be expected that additional taxes will be more useful against inflation than tax concessions will be in promoting recovery In certain circumstances it is conceivable that additional taxes might even promote recovery

In discussing the means of fighting inflation it is desirable first to distinguish the type of the phenomenon, since the usability and effects of particular tax devices will not be the same in all circumstances Thus we may classify (i) a situation of actual war, (ii) a situation where inflationary pressure is primarily due to the impact of defence expenditure impinging on conditions of fairly full employment (a cold war), and (iii) an investment boom resulting from exogenous causes such as the sudden exploitation of a new technique, or merely a spate of simultaneous replacement of a large amount of industrial equipment

Such a bunching of investment has been a common experience in the past and there is no reason to believe that it will not occur again in the future It goes without saying that much more experience and empirical investigation is required before anything like a mature judgment on the relative merits of different devices can be formed Here we can do no more than indicate the most obvious lines of attack It must be borne in mind that in no circumstances need fiscal policy bear the whole burden of preserving stability In war-time it is probable that the heaviest work will be undertaken by direct controls, in other circumstances credit control can play an important, if probably subordinate, part

Anti-inflationary tax policy in actual war conditions is not difficult to define We can say at once that capital taxes, such as death duties, will be of very little use indeed, because they do nothing to transfer current resources to the government, and because they have little or no effect on current consumption Indeed a rise in death duties may, in the short run especially, actually stimulate spending In war-time shipping difficulties are likely to limit the use of outlay taxes as

instruments of control, in a country that relies on imported raw materials this is as true of excises as of customs duties. Main reliance must therefore be placed on income and profits taxes. In war-time the normal danger to incentive of a sharp rise in personal income tax is much reduced owing to the strong desire to end the war. Moreover progressive personal tax has itself a built-in stabilizer, as prices rise the effective exemption limit is lowered while the progression becomes stiffer in real terms.

Under the British system of taxing undistributed profits mainly within the income tax a rise in the standard rate will also impinge on "impersonal" incomes. It will no doubt in addition be desirable to exert a further pressure on profits, and one that operates more quickly than income tax, payable on the previous year's profits. In modern wars it has been customary, both in Britain and other comparable countries, to meet this need by an excess profits tax, but we have argued above[1] that this is not really desirable on economic grounds in any circumstances, both because the intensity of the marginal effects is dangerously disincentive, even in war-time, and because the desire to avoid taxable excess leads to inflated costs and other bad habits of management. Moreover it will in any case be desirable to have some additional tax to meet the case of firms who have no taxable excess, in the manner of the National Defence Contribution between 1939 and 1945. Nor should it be necessary in future to resort to an excess profits tax, at least on economic grounds, since the main burden of price stability can now be taken by direct controls. It seems therefore that in a future war an additional tax on total profits would be sufficient. This perhaps constitutes an argument, although not a very strong one, for retaining a separate profits tax in the normal structure, if so, in quiet conditions its rates should be strictly moderate.

In spite of the limited usability of outlay taxes in war-time, where a commodity is not amenable to rationing (such as tobacco) or where equitable rationing is difficult (such as

[1] See pp 198ff

petrol) a stiff rise in rates may be a useful support of direct controls In addition a highly selective purchase tax will assist to direct consumer demand away from scarce commodities By and large, however, the control of consumption in war-time will normally be the task of rationing and other direct controls

When we are once again faced by an old-fashioned investment boom the problem also should not be difficult, in view both of the greatly expanded size of the public sector, which must be trusted not to act perversely, and of the many new weapons now available, not least the better facilities for forecasting In fact the difficulties are more likely to be political than economic, so long as there is any unemployment Parliament will be reluctant to admit the existence of boom conditions The implication of this psychology may be a continued bias in an inflationary direction, but it is just here that the revival of credit control can play as especially useful part, changes in interest rates do not call for Parliamentary action and they operate much less discontinuously than fiscal changes So far as strictly fiscal measures are concerned the application of a selection of those appropriate to the more severe conditions of the cold war would probably be sufficient To this more difficult problem we must therefore turn

Although as regards the means at our disposal we are now much better equipped for fighting severe inflationary pressure in time of peace than ever before, in one sense the situation is less favourable the rates of many taxes are now so high that any increase brings with it a danger of recoil in the opposite direction Thus it has been widely argued that a rise in purchase tax is useless as a measure of control because it will immediately lead to rises in money wages Carried to its logical conclusion this argument leads *ad absurdum* both to raise and lower taxes will be inflationary It has been similarly argued that a rise in workers' income tax will be transferred to consumers *via* higher wage rates leading to higher prices

For these results to occur very special assumptions must be made concerning credit policy, too easy money will allow

demand to expand in money terms *pari passu* with the rise in tax liability so that no contractionary effect occurs If the taxes are to have their correct effect therefore credit policy must first be attended to More serious, because more difficult both to assess and to deal with, is the possibility that output may decline through the disincentive effect of a rise in personal income tax, especially at the weekly wage-earner level In this case, in spite of tax measures, the inflation will be kept going by a shortage of goods Apprehension on this account led to a steady process of raising the exemption limit of British personal income tax, by various devices, onwards from 1945

In spite of the fact that income tax has a built-in stabilizing effect it must be admitted that out of war conditions it is by no means an ideal[1] stabilizer By taxing saving it penalizes directly those who refrain from drawing on the available supplies of goods, while giving no reward to those who do their best to increase them Thinking along these lines (especially the former) economists have, as we have seen, long searched for a means of exempting savings from income tax The present reliefs for particular forms of saving, such as life insurance and house mortgage interest, are the sole fruits of these efforts

More recently it has been suggested that the right solution would be an Expenditure Tax This would differ from even the most comprehensive sales tax in that it would be assessed at progressive rates on cumulative total expenditure over the year If it proved practicable it would in a sense be more flexible than income tax, since there would in principle be no limit to the rate of progression that could be charged, whereas an income tax must inevitably become proportional some way short of 100 per cent In fact, owing to the narrower base of an

[1] It has been argued that if capital gains are included in income the tax is a much more powerful stabilizer In principle this cannot be denied, but it is just in conditions of inflationary price rise when many of the money gains represent no real gains (sometimes even real losses), that it is most difficult to operate the tax equitably Further the stability achieved is not so great as might appear at first sight, since the gains can only be taxed when they are realized, not when they are made

expenditure tax (due primarily to the exemption of saving), rates would have to be very progressive indeed if the revenue were to be comparable with present income tax revenue A progression up to 400 per cent on total expenditure would be by no means ruled out

The advantage of an expenditure tax as an anti-inflationary device would largely turn on the extent to which it encouraged saving While it is clear that there would be an immediate premium on not spending, this would disappear the moment the savings were spent, and if they were spent within a single year the premium would be considerably more than swallowed up by the heavy progression of the tax It must indeed be questioned whether "ability to pay" can be as well measured by outlay as by income, too often expenditure, especially heavy expenditure within a short period (which would attract the higher rates of tax), reflects exceptional needs rather than exceptional ability, needs such as the unavoidable purchase of a house when moving employment, or the supplementary expenses consequent on illness To a limited extent, it is true, certain types of expenditure considered socially desirable, or shown to have been due to a personal emergency, might be exempted from the tax The wider the range of exemptions, however, the higher must be the rates and progression on the remaining expenditure

In a minor way all outlay taxes follow the Expenditure Tax in penalizing spending, but having little or no adverse effect on saving, they are thus on *a priori* grounds good inflation fighters, especially where the demand for the taxed goods is so inelastic that there is no escape by substitution In British conditions so far taxes on tobacco have proved ideal

No anti-inflationary fiscal devices can be fully effective which impinge only on consumption, it may be even more necessary to cut back investment We have already seen the importance in this respect of varying the terms of depreciation allowances, but something more drastic might be required In the Korean boom the Swedish government experimented with an expenditure tax on investment, the revenue being reserved for future

development of the industries concerned, there may be something to be done along these lines However, it is just here that credit control is at its most useful Experience in 1952–53 demonstrated that holding of commodity stocks is still very sensitive to money market conditions Now that many producers' goods are bought on hire purchase (especially in agriculture) a stiffening of hire purchase terms, including mortgages, might be even more effective than the same measures applied to consumers' durables

The part which tax changes can play in sustaining effective demand in depression is, as we have seen, not likely to be very powerful It is doubtful how far a relaxation of personal income taxes would be translated into additional spending in the short run Nor, since demand tends to be inelastic, would relaxation in tobacco or alcohol taxes be likely to have much immediate effect If a general expenditure tax were in operation its relaxation might have a powerful effect, a similar although much smaller effect could be obtained by a relaxation of purchase tax rates, were it not for the difficulties caused to retailers who would be selling goods at lower tax rates than they had bought them for This difficulty does not exist when tax is levied at the retailing rather than the wholesaling stage, and must be set against the great administrative advantages of collection from a small number of wholesalers rather than an enormous number of retailers For the main instruments for fighting depression we must, however, turn to the expenditure side

§ 4 **Attack from the Expenditure Side** It is particularly on the expenditure side that the great increase in the size of the public sector should facilitate the maintenance of a high level of activity Further, we need not expect again to be faced with such a complex of unemployment as plagued the British economy in the 1930s It is nevertheless desirable to distinguish the different types of unemployment, since all are likely to occur in some measure in the future Unemployment in an industrial country can broadly be divided into three types frictional, cyclical and secular (or long period)

Frictional unemployment is merely that which inevitably arises in a world of change and imperfect foresight, when one industry or firm declines and another expands Some little time must usually elapse even when conditions are good, before workers who have been laid off find re-employment elsewhere It was precisely for this problem that the employment exchanges were established, for many years conservatism and unfamiliarity militated against their full usefulness being realized, but the experience of war and post-war labour shortages seems to have broken down earlier inhibitions, this, together with better education and better statistics, make it unlikely that of itself frictional unemployment need be a serious problem This hope is supported by the very low levels of unemployment which have been attained in recent years

Secular unemployment may be regarded as aggravated frictional unemployment Where large industries are declining, as cotton was in the inter-war years, so great a number of workers become redundant that they cannot quickly be reabsorbed Their standard of living and their industrial skill deteriorate as the months of worklessness stretch into years, prolonged part-time working has almost as serious effects on productivity and morale In the 1930s the hard core of the unemployment problem was thus the "long unemployed",[1] largely concentrated in the areas of the country where whole industries had fallen on evil days These men had been thrown out of work by the collapse of the post-war boom of 1919–20, and before they had found satisfactory new jobs the slump of the early 'thirties was upon them A solution was eventually reached by the passing out of employment of the older workers and the reabsorption of the others in the labour scarcity of the second world war The danger that frictional unemployment may lapse into secular is endemic in any economy which is not rapidly expanding, but here again we should start in a better position than in the 1930s There is now no backlog of long unemployment, for those who are not quickly reabsorbed into their own or similar jobs much better facilities exist for training

[1] Cf *Men Without Work*, written for the Pilgrim Trust

and resettlement, and much better understanding of the advantages which these offer

In spite of the efforts of semi-public organizations[1] in the 1930s to induce these firms to open factories in the declining areas, and in spite of the rate and rent concessions offered to new factories by some local authorities, by and large, new work for the unemployed could only be found by migration to more prosperous areas This led to formidable social and economic problems for those left behind, as well as to financial problems for the local authorities, who strove to supply normal local services out of an ever-dwindling rate fund Since the end of the war, policy was been substantially reoriented The Location of Industry Act (1947) gives statutory authority which includes the direction of industry to what are now known as the Development Areas More extensive fiscal concessions are available, and considerable experience has been gained in locating new factories in formerly declining areas

There are, however, limits to the benefits of a policy of taking the work to the workers Migration and inconvenient location usually imply additional production and transport costs, these are a social as well as a private loss and must be set against the social and economic loss of continuing decline So long as "direction" could be implemented by the allocation of scarce materials, including bricks and mortar, "voluntary" migration of firms could be counted upon Now that this is no longer the case a government might put itself in an awkward position if it has used the statutory powers to the full and the migration had resulted in bankruptcy However, in this field especially success breeds success The development areas now offer both much better living conditions and a wider local market than they did in the 1930s

The prospects of redeploying workers who have become redundant ultimately depends on the rate of expansion of new industries, and so on the rate and application of technical

[1] Such as the Special Areas Reconstruction Association, and the Nuffield Trust For an account of their work cf U K Hicks's *Finance of British Government*, cit, Chapter XIII

inventions Fiscal methods of stimulating this belong to the discussion of the next chapter Again, however, there is reason to believe that we are better placed than we were in the 1930s It should be emphasized, however, that while new techniques are important, their effectiveness depends entirely on their productive use, and this is the joint responsibility of the public and private sectors of the economy

By far the most important type of unemployment in modern economies has been cyclical, this was the typical problem of all countries in the 1930s, we can have no assurance that we shall not again have to fight it, perhaps at very short notice It is in this direction that the responsibility of fiscal policy is greatest, but fortunately it is in this sphere that its weapons are most appropriate The essence of success in fighting cyclical unemployment is speed, it is vital to support effective demand before it seriously flags and the multiplier in reverse has had time to work out its evil effects Timing is, however, also the most difficult aspect of policy implementation Not only is it difficult to recognize when, and how much, action is called for, but after the need has been diagnosed, and appropriate expenditure set on foot, in most cases a considerable time elapses before the works make a useful contribution to the demand for labour In the 1930s even those countries which started earliest and tried most earnestly to fight the slump by public expenditure (such as Sweden and Australia) only got their works to a useful point long after the worst of the slump was over

In the acceleration of public works obstacles and delays may arise in three directions first there is the time required for planning and blue prints, secondly the necessary contracts may require much time for completion, especially if they are concerned with land purchase, and finally in the majority of projects the demands for resources expands only gradually, so that it is a matter of months or even years before the peak demand for labour and materials is reached [1] Many

[1] Cf Bretherton, Burchardt and Rutherford, *Public Investment and the Trade Cycle*

suggestions for telescoping these processes, such as the "shelf" of ready planned projects, have been made While pre-planning can clearly save delay, if the plans have been worked out some little time previously they will still probably require considerable revision before they are ready for execution Works requiring little land usually show a quicker reaction than others, certain types of defence expenditure are therefore especially useful as reflators Thus orders for army uniforms helped to fight the textile recession of 1949

There is clearly no way of overcoming these timing difficulties completely, but the position is probably somewhat better in Britain to-day than it was in the 1930s Under the Town and Country Planning Acts local authorities are obliged to draw up twenty-year plans of land use in their areas, these plans have to be revised every five years, so that they can never be very out of date While not themselves blue prints for actual works the existence of these plans should both save time and remove uncertainty Secondly, local authorities have before them a number of urgent investments not requiring extensive land purchase (and in any case this has been made easier by the same Acts) Among these are the Medical Centres (one for every 10,000 of the population), without which the full benefits of the National Health service cannot be realized, many new and additional schools, and in the background the ever-present need for slum clearance

On the financial side also a number of former obstacles have now been removed In the 1930s a serious difficulty was that while the outlines of policy were determined centrally, the detailed planning and execution and much of the necessary finance was a local responsibility So far as current account expenditure is concerned (which would include planning and costing and no doubt some of the actual outlay at the site), the situation has been considerably eased by the fact that for all sub-average authorities the Equalization Grant (of 1948) is adjusted upwards for every rise in rate poundage

A further difficulty was that formerly for capital expenditure the smaller and poorer authorities were in practice compelled

to borrow from the Public Works Loans Board, which, concerned primarily with its own solvency, of necessity charged rather high rates Through a completely mistaken transference of ideas from the private sector, such authorities were regarded as a bad risk by trustees seeking mortgage investments, this simple method of raising funds was therefore closed to them At the same time stock exchange loans were beyond their means, even had investors there taken up a more sensible attitude

From 1946 all authorities were required to borrow only from the Public Works Loans Board, the dice were thus no longer loaded against the small and poor areas Moreover the policy of the Board soon showed itself to be completely changed No longer bound by considerations of its own financial soundness, it was used by the government as an instrument for providing local authorities with loan funds at subsidized rates (mainly for Housing) While this is not necessarily desirable, it is clear that a new means of assisting local authorities to take up projects is now available More recently the right of local authorities to borrow directly from the private sector has been restored, although subject to the direction of the Capital Issues Committee so far as stock exchange issues are concerned At the same time the new facilities offered by the Public Works Loans Board have not been withdrawn Hence for projects which fall within the range of national policy long-term finance should no longer be an obstacle

The importance of seeing that local authorities take rapid and consistent action in incipient depression is, however, no longer so great as it was in the 1930s, through the expansion of its own investment, including that of the nationalized industries, the central government can now take an important direct part in compensatory finance on the investment side Like the local authorities the public corporations must have development plans, in fact all have large projects ahead and all are subject to Ministerial direction, so that their timing can be determined, so far as it is economically desirable to do so Their borrowing is also strictly controlled

Viewed from the angle of compensatory finance, however, the investments of the public corporations probably have only a limited usefulness Many of the programmes (such, for instance, as new power stations and new coal mines) only gradually work up to a substantial demand for labour and often require years, not months, for completion, moreover they cannot be accelerated and decelerated without much more economic loss than would occur from the similar treatment of a road or housing programme This is not to imply that the fact that more than half of the capital formation of the British economy is now concentrated in the public sector does not open up important new potentialities for compensatory finance

In one respect, however, the situation would probably be more difficult than it was in the 1930s Then, thanks mainly to the exceptionally favourable terms of trade, there was no need to apprehend balance of payments difficulties for any feasible expansion of public outlay This situation may never be repeated, nor indeed is it very desirable that it should be, since the impoverishment of our customers, due to the unfavourable terms of trade with which they were faced, was an important factor in the intensification of depression

Even in this sphere, however, there are new grounds for hope, on the one hand the assistance of the international financial institutions (the Monetary Fund, the International Bank for Reconstruction and Development and their agencies), on the other hand there are improved possibilities of maintaining overseas effective demand by government commodity purchases for stock With the more difficult balance of payments position, however, it is clearly the more necessary that compensatory action should take place before depression has taken hold, so that the amount of action required, and the consequent pressure on the balance of payments will alike be moderate

CHAPTER XVIII

FISCAL POLICY AND GROWTH

§ 1 **The Opportunities for Fiscal Policy** In the last chapter we were primarily concerned with compensatory finance, but measures which stimulate recovery, especially on the investment side, will also tend to stimulate growth. The adoption of a quick write-off of new capital assets and the maintenance of long-term interest rates at as low a level as is consistent with stability, as part of a normal programme, will help to create an atmosphere congenial to growth. We have consequently now to consider here measures which are specially designed to stimulate the long-period expansion of the gross national product in real terms.

At the same time it must be remembered that some of the measures undertaken primarily on social grounds, but with an eye also to the cyclical maintenance of effective demand—such as a more equal distribution of disposable incomes—may in conditions of full employment be inimical to growth, because they tend to expand consumption at the expense of saving, and hence of investment, both directly and through the repercussions of the high progressive taxes which accompany them. To some extent, to be sure, this anti-saving bias in the private sector can be compensated by an increase in "saving" in the public sector through budget surpluses, but if these in turn are not to have a further effect on the volume of private savings they must be secured by taxes which are not highly progressive. Hence the mere existence of full employment is by no means necessarily favourable to growth.

The emphasis on the state's part in promoting economic growth, which is now so striking and universal a feature of policy, is of recent origin, or perhaps it would be more accurate to say revival, because we have seen that it already existed in

eighteenth-century Britain In the developed countries, especially in Western Europe, this new interest is compounded of the fear of a return to the stagnation of the 1930s and of anxiety concerning the balance of payments *vis a vis* the dollar, in the face of the apparently amazing increase in productivity on the North American continent Although in the U S economy the process of growth seems for the time being to be sufficiently assured by private enterprise, in fact something like a revolution in the position of the state has occurred, to an extent that is not generally realized Vast sums are currently spent by Federal agencies, such as the RAND corporation (*R*esearch *and* *D*evelopment), primarily on research, much of which is "fundamental" in the sense that it is geared to the general improvement of the efficiency of technical processes, rather than to the solution of specific problems Nor does the state's share end with research, definite orders are placed by the government, for instance for prototypes of aeroplanes and so on, which otherwise could not be undertaken by private enterprise on the same scale

A similar part is played by British government departments, although on a smaller scale Further, in both countries (and in others also) atomic research is primarily being developed by public enterprise, notwithstanding that its object is economic as well as military Government research projects are also undertaken by firms and in universities, thus making funds available to wider groups of research workers The universities in particular are now much more ready than formerly to accept public money for research work, presumably because they are satisfied that conditions which might hamper the research worker will not be attached to the grant This in itself is an indication that the nature of the work is general rather than particular The fact that these new directions of public expenditure were originally motivated by defence needs is in practice of little relevance to their contribution to general economic development In fact progress may actually be speeded by the fact that defence expenditure is commonly more readily agreed to by legislatures than outlay on research with

a vague mandate for the improvement of economic efficiency The fruits of this new activity of the public sector may be found in the extremely rapid growth in the discovery and application of new materials and techniques which has taken place since 1940

The new emphasis on growth, and on the part which public activity can take in it, is even more striking in the poor and backward countries than in those we have been discussing Here it is compounded of a new consciousness of backwardness due to extended contacts with other ways of life during the war, of new opportunities on the financial side due to the swing in the terms of trade since 1940 in favour of primary products, and in many cases on the political side by a greater freedom and greater urge to develop In many tropical countries also an improvement in the gross national product, especially on the agricultural side, is a sheer necessity in order to maintain the pre-war standard of living, since the improvement in tropical medicine and insecticides has removed former brakes on population growth

The change in the attitude of the richer countries *vis a vis* the more backward is hardly less important The part which the former are now prepared to play, either directly or through the new international agencies,[1] is in strong contrast to the neglect of the backward countries in the 1930s, although perhaps not (in terms of scale) in relation to several periods of the nineteenth century and the first decade of the twentieth century The fact that the motivation for this assistance is partly political again has little relevance to the types of development assisted or to its benefit to the developing countries

The fact that substantial assistance may be available does, however, strongly affect the fiscal policy of the developing countries, since practically none of them possesses sufficient reserves to take full advantages of their existing resources On the one hand they are concerned to gear their public finance (and especially their taxes) so as to attract outside capital, but

[1] Such as the International Bank for Reconstruction and Development, the U N Technical Assistance Administration and the Colombo Plan

on the other it must be shaped so that their own nationals are induced to forsake their accustomed ways and to undertake new and often strange processes of production It is equally necessary that fiscal policy shall ensure that the recipients of rising incomes (due to development) will not cash in the whole of their surplus in improving their own standards of living, but will tighten their belts sufficiently to allow the process of development to gather momentum Space does not allow us to examine in detail the special problems of the developing countries, but many of the difficulties which they face are of general application

Fiscal policy is capable of contributing to growth in four different directions First there is the part which public expenditure may play, either directly or on behalf of private enterprise, secondly comes the choice of revenue adjustments which must be made both to provide funds to cover the outlay and to preserve stability in what (as we have seen) is an inherently inflationary process Thirdly within the field of fiscal policy fall the problems concerned with providing the necessary loan funds for capital formation, and for the management of the debt incurred Finally there are a number of important organizational and planning problems to be solved if the best use is to be made of the limited resources available These problems lie on the borderline between administration and fiscal policy, and so partly at least outside our field, but some aspects (especially those concerned with the organization of the budget and with inter-governmental financial relations) are closely tied to fiscal policy In the present chapter we shall be concerned with the first two of these aspects of fiscal policy, in the two remaining chapters we shall deal briefly with the others

§ 2. Public Expenditure for Growth Broadly speaking there are two ways in which public expenditure can contribute to the expansion of the gross national product In the first place the state is responsible for providing the basic economic foundation in the form of "overheads" of an economic or social nature

without which existing resources cannot be made fully available or put to their best uses In the second place public expenditure can increase economic productivity directly, both by providing assistance for the establishment of new industries and the introduction of better agricultural methods, and by itself undertaking production and trading, especially of a type not hitherto attempted in the country Into this category would fall the research work of the government and its agencies, applied to the special local conditions of the economy These applications of public expenditure to development are general for all types of countries

Although the basic economic overheads, such as the transport system, have long been established in developed countries such as Britain, this is by no means the end of the story, technical change calls periodically for replanning Thus the British road system has fallen seriously behind that not only of the U S A but also of a number of less wealthy countries in Western Europe, because no serious attempt has been made to catch up with arrears since 1940, much less to build a modern system of through roads which the growth of road traffic has shown to be necessary Nor have any effective steps as yet been taken to forge the essential links in the traffic system, such as the Severn Bridge The railways themselves also call for drastic reorganization before they can become efficient in their still important although reduced role The road system is a matter in which (as we have argued earlier) it should not be difficult to establish objective priorities for development (time saved per unit, multiplied by the number of units, on alternative stretches of road) Nor need there be any serious financial problem if the sensible plan (now used by most other countries) of charging for the use of newly built highways is adopted This is partly a budgetary question to which we shall have to return later

In most underdeveloped countries inadequate transport systems, both road and rail, are serious obstacles in the path of growth, a further trouble very commonly encountered is the inadequacy of port facilities, leading to delay in clearing both

exports and imports These bottlenecks tend not only to reduce overseas income, but also make it more difficult to preserve internal price stability The optimum solution for a really underdeveloped and largely uncleared country, including a correct balance between road, rail, water and air transport, is by no means easy to determine No simple calculation of relative cost and benefit will meet the case and consideration must be taken of the particular local situation, in respect of such factors as type of terrain, amount and distribution of rainfall, road metal available, and so on On the other hand many obvious improvements are usually available, and within their limited sphere it should be possible to establish objective priorities, without delaying the course of the major decisions What is required above all is a greater awareness of the key importance of economic overheads in advance of any large-scale development, if full advantage is to be taken of industrial and agricultural improvements as they occur

Parallel with the need for the extension of economic overheads in underdeveloped countries is the need for a greater provision of social overheads, especially in the direction of education and public health, but here, in a sense the financial problem is easier In the first place there is much awareness of the desirability of such developments, greater local demand should (and often does) imply greater local willingness to foot the bill, thus tapping additional sources of revenue For the most part also the installations call for less heavy capital equipment than economic overheads (this is not true of general hospitals) The fiscal problems in the field of social overheads are hence primarily those of control and of such an allocation of priorities as will best improve the national product Social overheads commonly raise powerful local vested interests whose votes are frequently important With their more limited resources it is especially important that poor countries should avoid "open-ended" expenditure, such as contracts with private agencies for services the development of which they cannot control As we have seen it is all too easy for rich and developed countries to overtop the bounds of economic wisdom

in the social services, sacrificing the benefit of the many to the special favour of the few, for underdeveloped countries the danger is still greater

Concerning the provision of overheads of all sorts there is, however, the fundamental financial difficulty that their direct contribution to fiscal potential is negligible while their beneficent indirect effects are likely to be realized only slowly over a long period, through the expansion of the national product The provision of social overheads indeed in the short run not uncommonly creates more difficulties than it solves, for instance by hastening the break-up of an existing social structure before the new economic structure is ready to absorb the labour set free This strengthens the argument for watchfulness and caution, the cost in terms of alternative use of resources needs to be constantly weighed

Economic overheads and true economic development often merge into each other The touchstone of the latter is that the works pay for their keep in the sense of making no net call on the revenue, either for current outlay or for the service of the debt incurred in providing them In addition they should be expected, when they are fully in operation, to provide a surplus of saving for further development, thus contributing to a dynamic process

On the borderline of economic overheads and economic development are the provision of the basic conditions for the improvement of productivity in industry and agriculture, especially electric power, flood control, drainage, irrigation and other methods of soil preservation and enrichment These services are true development, but like overheads they yield their full fruits only over a long period, this is especially true of major works which commonly take some years to construct Such works should not, therefore, be neglected, in general they offer the best hope of a permanent increase in the productivity of factors As well as such major works there are likely to be many more minor works available which will raise productivity more quickly in the short run, but in the long run less effectively There is often a tendency to push ahead with

these because they call for less belt tightening No harm can result from this so long as the minor schemes have been fitted into a definite programme of development If the small projects are preceded with haphazard, however, funds are apt to be frittered away without securing the best use of resources

The basic problems in the field of public expenditure for development (especially in backward countries) are two (i) the extent to which industrialization should be encouraged for its by-products (in terms of habits of regular work and technical skill), apart from the value of its net product, and (ii) the extent to which the state should take a direct responsibility in industrial and agricultural projects, in preference to giving its aid and support to private enterprise These involve matters on general policy which lie quite outside our field, but at bottom they ultimately turn on economic and fiscal considerations

It should continually be borne in mind that an industry which does not cover its costs without subsidy detracts rather than adds to the national product, it would be more proper to regard it as a type of social service, which should consequently be integrated with the social rather than the economic programme, and reckoned as an additional charge on the revenue In very many cases also the potential market which the industry might serve (within any reasonable planning period) may well be too restricted for economical working of even a single plant Where a large potential market is available, but local know-how is lacking and overseas capital hard to attract, there is a strong case for state operation or participation, since in that way the availability of technical advice and training may be improved

The least controversial field for public expenditure for development is in improving the technical conditions for the establishment of industry and for raising the productivity of agriculture Under this heading we may include such things as the provision of capital funds on reasonable conditions, and in the quantities required by firms making a start, the provision of information, suitable sites, legal assistance in the acquisition of land and so on, so that the special local risks may be minimized, and the undertaking of technical research into the

adaptation of machinery appropriate for local conditions of climate and labour skill None of these need entail a heavy net cost on the revenue, since they can be recouped from the beneficiaries over a period in most cases

Experience of developed countries, not excluding the United Kingdom, suggests that services of this kind can most appropriately be undertaken by public authorities, more or less directly under government departments Examples are the finance corporations set up in the 1930s and strengthened after the end of the war, to ensure a supply of funds for small firms[1], this sort of assistance is even more urgently required in backward countries, and indeed many of them are already supplying it Similarly the "trading estates" which were established in Britain first by private enterprise (as at Slough and Trafford Park) and later by public corporations in the Development Areas, go half-way to meet the entrepreneur by providing him with site and factory on rental basis, with public utilities laid on In underdeveloped countries the obstacles which stand between a willing entrepreneur and adequate production conditions are still more formidable, and may be greatly complicated by such factors as tribal systems of land tenure Trading estates would seem to be especially appropriate for meeting these difficulties

Even in developed countries again it has been found that equipment designed for one set of physical conditions is almost useless in another Thus the coal mining machinery eagerly imported into Britain from the U S A after the war was found to be largely unusable in British geological conditions This sort of experience is almost certain to be repeated in tropical climates with unskilled labour In the agricultural sphere the work that needs to be done in this direction, for instance in soil diagnosis, appropriate use, selection and breeding of seeds and stock, and the adaptation of farm machinery, is even more important, since of all development food production must come first

[1] In order to fill the "gap" diagnosed by the (Macmillan) Committee on Finance and Industry

§ 3. **The Contribution of the Revenue Side** The revenue side of public finance has a heavy responsibility in the successful promotion of growth The additional need for taxation which government-sponsored development implies can probably in any case not be met without some additional burden In the developed countries, as we have seen, tax rates are already so high that any increase runs the risk of exerting an effect contrary to the one intended, for instance by reducing incentive, or (if credit policy is not on the alert) by stimulating inflationary price rises In an underdeveloped country the tax structure is likely to show signs of strain at much lower rates of tax, due to the inexperience and lack of education both of taxpayers and tax collectors, as well as to difficulties due to the undeveloped types of business organization Indeed it is characteristic of a backward country that the state succeeds much less well in taxing such wealth as is available than in a rich country

The business of the revenue during a process of development is twofold on the one hand it must find the funds to finance the necessary contribution of public expenditure in the ways we have just examined, at the same time it must exercise a sufficient restraint on the economy to eliminate anything above a mild and controllable inflationary pressure In addition to these primary purposes the revenue itself can serve to stimulate the process of development While the extent to which it can do this is often exaggerated, it is obvious that the necessary taxes should be geared so as to minimize risks and disincentives, especially for intending entrepreneurs These three objectives do not by any means necessarily lead to the same choice of taxes Constraint needed to preserve stability may deter enterprise, over-eagerness to encourage industrialization may lead to an undue sacrifice of revenue

The major problem of the revenue is concerned with the first two of the above objectives It can be, and frequently has been, argued that a small degree of inflation actually greases the wheels of development Resources are transferred thereby from fixed income receivers to the government, the revenue is buoyant and gently rising prices stimulate enterprise Such

a process appears much simpler and less painful than that of raising sufficient revenue to avoid the upward drift. Attractive as this argument is, it is not a safe one for countries who are in earnest about development.

To begin with, the process of transfer of resources to the government is not nearly so effective as it would be in a more developed country because the taxable fixed income receivers are few; moreover such savers as there are may well be discouraged by the fall in the real value of their savings. Unless ample reserves are somehow available to counteract the tendency for prices to rise by importing additional consumers' goods, there is a grave danger of balance of payments difficulties. It is the more difficult to diagnose the position correctly because reactions tend to be slower than in a developed country with rapid communications, so that a substantial inflationary potential may be built up before the danger is realized.

The responsibility of the revenue for preventing inflation from getting out of hand is also much greater than in a more developed country, because the other instruments of control are much weaker. Direct controls are difficult to work and seldom equitable. Normally speaking, poor countries are financially dependent on some richer or larger neighbour and do not have a developed system of financial institutions. Thus, even if a reserve bank is available, it is not likely to have much power of control, which calls for both banking habits on the part of the business community and at least some provision of banks with extensive interests in the country. In one sense indeed the absence of financial institutions implies that the sort of speculative boom (in commodity stocks and stock exchange securities) which has so often interrupted the smooth course of development in the more advanced countries is not likely to occur. Its counterpart, however, is the speculative land boom, with savings leaking away from industrial development and subscriptions to government loans into mortgages and luxury building. In the next chapter we shall touch on methods of public borrowing which may help to avoid this difficulty,

the surest method, however, is to ensure that the tax structure can take it We must therefore consider carefully what part in this process different taxes can play

The traditional taxes for financing development are import duties In certain conditions they may aid in all three of our objectives additional revenue can usually more easily be collected through the customs than in any other way, the revenue will tend to come out of the pockets of just those elements in the economy whose incomes have most advanced, and finally new industries can be fostered behind the shelter of tariff walls, which may both stimulate local capitalists and attract outside firms anxious to retain their markets [1]

The usefulness of import duties in a process of development, however, is often much exaggerated It is by no means certain that the duties will impinge where the additional incomes are situated, if they are imposed on luxuries the fraction of the economy affected may be too small to ensure control, if they are imposed on articles of mass consumption they may be found intolerably regressive, the margin by which the lower incomes can be repressed is pitifully small The difficulty arises essentially from the smallness of the middle class with easily taxable consumption habits Again, infant industries notoriously tend to be Peter Pans, and before deciding to support them with a high tariff the government would do well to inquire whether any of the obvious conditions for success exist, such as cheap power, indigenous and low-cost raw material or large potential markets If this is not the case the only argument in their favour is the external economies of skill, training and urbanization which they may promote Poor countries cannot afford to pay too high a price for these

This is not to deny that import duties can be a major aid to development, as a shelter for infant industries they are in any case much to be preferred to any system of guaranteed

[1] The favourable effect of import duties on the terms of trade, so much advertised in developed countries, is rarely likely to be important in underdeveloped countries because they are unable to influence world prices

monopolies which will neither produce so much revenue nor give as good a guarantee of efficiency as a moderate tariff. In most cases it will be necessary, however, to support the import duties with excises, which will be more or less usable and useful according as excisable commodities are manufactured locally. Almost everywhere duties on tobacco can bring in a large revenue and alcoholic liquors are usually dependable. In very many cases the revenue position could be improved also by ensuring that service charges, especially for postal services and harbour dues, really cover their costs, even if this implies some lowering of service standards. British standards (for instance of postal delivery) are by no means necessary in more primitive conditions.

A variant on the use of import duties to promote development is the imposition of export duties, normally on primary commodities. During the boom of 1951–52 a number of developing countries used these to great effect. In conditions of world boom it is not only natural that primary producing countries should make the most of the favourable terms of trade which fortune has handed them, but it is actually desirable that they should do so from the world point of view, since stability is thereby aided both in the importing countries, who will thereby be restrained from bidding against each other, and perhaps to some extent in the exporting countries also.

But export duty revenue of this type is likely to be short-lived; in the longer run the attempt to exploit inelastic demands inevitably leads to the expansion of alternative sources of supply or of substitute commodities. It is therefore not safe to count on such revenue for the finance of any continuing service.

Export taxes will also contribute to stability in the exporting country, especially as they impinge directly on those sections of the economy which are reaping the greatest advantage from the export boom. An alternative method of achieving the same result is by means of government agencies or marketing boards which buy from producers at fixed prices and sell direct to foreign importers, thus imposing on producers as much forced

saving as may be necessary to preserve stability This is in principle a superior method to export duties, because the buying price can be simply adjusted, to approach the same flexibility an export duty would have to be imposed at *ad valorem* rates on a sliding scale The basic problem, so far as the home economy is concerned, is to choose a buying price or rate of tax which will preserve stability without impeding enterprise This, however, is a general problem of price control and not confined to export taxes If export taxes are carefully used in this manner they can contribute intermittently very usefully to development, providing a fund out of which the import of additional consumers' goods to counteract the tendency for prices to rise can be financed, quite apart from their direct usefulness in paying for the import of capital goods

The alternative method to customs duties, both of preserving stability and of promoting the development itself, is through personal income and profits taxes As we have seen, personal income taxes are not ideal cyclical stabilizers, because at the high rates now usual in developed countries they may have serious effects on incentive This argument has much less force in primitive conditions, where rates of tax are normally substantially lower and the coverage much narrower There is little doubt that income taxes could be much further pressed in developing countries, and, further, as the now developed countries found before them, it is along this path that the ultimate solution of their revenue problems must be found The fundamental obstacle in the development of effective income taxes is normally the want of an expert and reliable inland revenue department Aid with building up this service should be given very high priority in requests for technical assistance It is only if he has confidence in the equity of the assessment and collection of tax that the taxpayer can be made to contribute adequately

The taxation of the profits of the small firm (which is likely to be the predominant form of business organization) will naturally fall within the scope of personal income tax, where indeed it will provide some of its worst headaches Most

developing countries have, however, a certain number of sizeable companies operating within their areas, which are likely to be partly at least owned overseas The encouragement of the establishment of large-scale companies is in many ways a most desirable objective of development policy, both because they offer the best chance of increasing the national product and raising the level of employment, and because they are exceptionally easy to tax For this very reason there is a temptation to exploit the company, especially the foreign-owned company, by high profits taxes If this is done, however, the establishment of new enterprise, both foreign and locally owned, may thereby be discouraged The government is thus on the horns of a dilemma between getting more revenue by an easy route, and one in which the foreigner largely pays, and taking measures to encourage what may be the most effective way of expanding the national product

In fact policy is frequently biassed by the type of output that is in question Mining concerns tend to be mainly foreign-owned and are unsuitable for local development with their heavy demands for capital and skilled labour, they are usually heavily taxed On the other hand, where there is some prospect of a general industrial development in which local capital can be induced to take part, governments tend to favour rather than to exploit, even though the concessions offered to industrial enterprise may imply a substantial loss of revenue This issue raises problems which are common to the process of growth in developed as well as in backward countries, although they are usually more acute in the latter

As we have seen, tax concessions allowing a quick write-off of fixed equipment, especially when supported by substantial "initial" allowances, have proved a most useful method of promoting capital formation in recovery This method is even more useful in the special conditions of uncertainty (concerning labour efficiency and other costs on the one side, and markets on the other) which beset a firm trying to set up in a backward country The question is whether such stimulus (which implies no ultimate loss of revenue) is sufficient or whether it

should be supplemented by further attractions Several lines of approach are possible In the first place an indefinite carry-forward of losses may be allowed (in place of the traditional limited period only) Secondly a choice of depreciation methods—either the "straight line" or "reducing balance" method may be allowed to the firm [1] Thirdly, carry-back of losses as well as carry-forward may be allowed, fourthly a special "investment allowance"[2] may be granted on top of the depreciation allowances, and finally a complete "tax holiday" for a defined period may be granted Many variations and combinations of these devices can be imagined

In judging these baits to entrepreneurs a distinction must be made at the outset between those which do and which do not entail a net sacrifice of revenue There can never be any objection to the latter, they represent merely an intelligent gearing of the tax to promote growth The former are more or less suspect according as revenue is hard to come by and concessions are wasted by covering those who do not need them In most cases a better result could be obtained by a general reduction in rates, the effect on the revenue of which can more easily be estimated than the result of special concessions

Carry-forward of losses is a normal concession to industries with fluctuating profits, little or no loss of revenue is involved even if the carry-forward is made indefinite (as it has been in Britain for some years) Carry-back raises a more difficult problem since it implies the repayment of revenue already collected If this is justified at all it would seem to be rather as a cyclical stabilizer in a developed country (which can easily resort to deficit finance) than as a stimulus to development Choice of method of depreciation entails no loss of revenue and has every justification as a factor in risk reduction, in some

[1] Under the straight line method a fixed percentage of the original cost is deducted year by year until the entire cost of the equipment has been recovered by the firm, under the reducing balance method the percentage is applied year by year to the written down and not to the full original cost of the equipment

[2] As introduced in the British budget of 1954

industries or circumstances a complete write-off within a defined period may be more attractive than a quick write-off of the major part of the cost of new equipment, and *vice versa*

To allow the depreciation allowance to blossom into an investment allowance is another matter Here revenue is definitely sacrificed, and it must consequently be asked whether the stimulus is at least commensurate It should be noted that the main additional stimulus to capital formation of the investment allowance is felt only at the end of the "revenue" life of the equipment, which is very likely to be too far ahead to play an important part in planning [1] Poor countries will therefore probably be well advised not to waste revenue on investment allowances

There remains the "tax holiday" for a definite period Apart from a possible psychological effect when it is first introduced, this device provides little stimulus to the pioneering firm for whom it is intended, it is unlikely to make important taxable profits within the relevant period, which cannot usually be set at more than five years On the other hand the very successful firm will be enjoying a quite unjustified immunity The crux of the problem, however, turns on the tax arrangements after the holiday period has expired If the customary tax on profits with depreciation allowances is then imposed (so that five-year-old machinery is effectively treated as new) then substantial revenue may be sacrificed If, however, this is not done the firm may be worse off than if the straight line method of depreciation with indefinite carry-forward of losses had been allowed, instead of the tax holiday

In the case of firms owned abroad the whole situation is immensely complicated by the taxes imposed by the country of origin This is too specialist a subject for us to be able to enter into it in detail here, although it is a factor of such importance that it may well be decisive in the decision to

[1] It is true that if the "reducing balance" method is used there will be a small additional stimulus in the second year, since that year's depreciation quota will be calculated on full, not written down, original cost

establish a plant in an undeveloped country [1] If no double taxation agreement exists between the two countries, the firm may be seriously deterred by having to pay the two taxes aggregatively Even if such an agreement exists, so that the firm pays the whole of the tax of the country with the lower rate, and the balance to the country with the higher rate, since the underdeveloped country is likely to have the lower rate the concessions it offers may be in vain, the firm must still pay its home rate of tax, and in addition face the extra hazards inherent in investment abroad

When all is said and done, however, it is very doubtful how far tax concessions in their own right really succeed in promoting development In Britain the rehabilitation of the depressed areas made virtually no progress under the rate concessions of the 1930s, the real change came only with the "direction" of firms thither (with the bait of the searce commodities, bricks, mortar and steel) in conditions of high activity In the backward countries the things that decisively swing the balance for the foreign investor are economic prospects in the widest sense, political security, including security of tenure, and reasonable facilities for the repatriation of dividends, and if necessary capital The services which the government of a backward country can offer through its expenditure to promote development are likely in the long run to be more helpful than the taxes it refrains from collecting

[1] The situation may also be different according as the foreign firm sets up a subsidiary or a branch in the underdeveloped country From the point of view of the latter the subsidiary is preferable, since it is easier to ascertain the taxable profits, the home country by the same reasoning will probably prefer to encourage the establishment of branches abroad

CHAPTER XIX

BORROWING POLICY AND DEBT MANAGEMENT

§ 1 The Significance of the Public Debt for Credit Policy As we saw at the outset, in modern conditions there are available three methods of implementing a general economic policy of stability and development the fiscal instrument, the monetary instrument and the method of direct control Outside of war and major emergency conditions (due perhaps to some natural disaster) the last must be regarded in a free society as a *pis aller*, indicating in part at least the inadequacy of management or misuse of the other instruments, both of which have the merit of preserving freedom of choice and enterprise in a way which direct controls make difficult

During the second world war direct controls played a most important part in the belligerent countries, in none more than Britain, at the same time the fiscal instrument fell into the background (this situation was tacitly recognized by the omission of the Chancellor of the Exchequer from the War Cabinet), while the monetary instrument was almost entirely directed to minimizing the budgetary charge of the war debt and was not applied to the purpose of control The fiscal instrument came to the forefront with the deliberate anti-inflation budget of 1948 (which as we shall see in the next chapter marked a most important stage in the technique of budgetary development) A decisive although tentative return to the monetary instrument as a support of general economic policy was made in Britain in the autumn of 1951, and at about this time by other countries whose policies had followed a broadly similar trend It was only in the autumn of 1954, however, that it began to appear as if the monetary instrument might be fully restored to something like its traditional importance

Monetary and credit policy as such cannot be regarded as falling within the field of public finance, more especially that part of it which is concerned directly with preserving external stability This remains true even although the institutions responsible (in Britain the Bank of England and the Exchange Equalization Account) are now publicly owned and formally subject to Treasury direction Nevertheless there is one aspect of the monetary instrument which lies so close to the field of public finance that it cannot be neglected, namely that part connected with borrowing policy and the management of the public debt Since the creation of the vast debt of the first world war (when the capital sum of the national debt rose tenfold) an indissoluble link has been forged between public finance and credit control Borrowing and debt management on this scale affect the whole economic background of a country Debt management is a public responsibility which cannot be shirked, because (owing to the structure of the debt) it calls for specific decisions of re-financing at frequently recurring intervals

This public responsibility is, however, also a public opportunity, in fact it provides an important new instrument of control The basis of this is that since the borrowing of the first world war (in Britain, in the U S A this situation was only reached in the second world war), public debt has dominated the financial markets Treasury bills have so much exceeded any other short instrument of indebtedness that their rate of interest (or more strictly discount) has set the pace in the money market, while long-term government debt (war loans and the like) has similarly dominated the capital market Although this revolution had been achieved in Britain by 1920 when the borrowing process of the war was complete, more than a decade elapsed before the public authorities were able to turn their responsibility into an opportunity

By the middle 1930s, however, the Treasury was unofficially recognized as the arbiter of monetary policy, exercised through debt management The Bank of England voluntarily regarded itself as under Treasury direction ten years ahead of its formal

nationalization in 1946 Thus the act of nationalization added in practice surprisingly little to the working of the control instrument That was already assured by the pre-eminent place of the Bank itself among British financial institutions, and in particular by its close physical and personal contacts with the commercial banks, themselves made more amenable to control since a series of important amalgamations carried through in the early 1920s had produced the dominance of the "Big Five" The "hint from Headquarters" was already effective in their operations long before it came to be formally inspired by the Treasury Nevertheless nationalization has undoubtedly strengthened the hands of the authorities in wielding the instruments of control, it has added something to their armoury in the way of control over hire purchase terms, and the revelation of details of certain deposits with the banks, which can materially add to the effectiveness of policy

It is our business in the present chapter to discuss the ways in which the (in a sense) fortuitous presence of a large public debt has within the present generation put into the hands of the government a new instrument of control which can be integrated with the more strictly fiscal instrument on the one side and with the traditional monetary instrument on the other This new situation is in some ways strangely reminiscent of that earlier revolution in British monetary affairs marked by the establishment of the Bank of England at the end of the seventeenth century, which carried British aims to victory against Louis XIV How much it will be desired to use debt management as an active instrument of control in the future is a matter of speculation, the situation has been changing fast over the last few years Further, the importance of a debt policy, and with it to some extent the effectiveness of the instrument, is probably at a maximum in the decade following a period of heavy borrowing, because it is then that the process of refinancing gives the greatest opportunities Nevertheless for the most part time cannot undo the change which has taken place in the control centre of the nation's monetary affairs

§ 2 **The Structure of the Debt** The traditional attitude to a large public debt has been that every effort should be made to pay off as much as possible from the moment that the need for new borrowing ceases This attitude was partly based on an analogy with private debt, on the consideration that the "dead weight" debt was similar to a private consumption loan, against which there would stand no assets for its support It was also partly based on the fear—probably largely imaginary in respect of internal borrowing—that the presence of a large debt might hamper future borrowing, and partly on the far from imaginary fear that the real burden of paying the money interest would increase to an intolerable extent if there were to be a general fall in prices (rise in the value of money)

In modern conditions the capital sum of the national debt is of negligible economic importance, the significant factors are on the one hand the internal structure of the debt and on the other the bill for debt interest, or more precisely the additional taxes that have to be raised to meet it These we shall examine below It follows, however, that the reduction in the capital of the debt is no longer of economic significance The process of repayment is almost wholly deflationary, the effect of the budget surpluses out of which alone it can be achieved far outweigh any expansionary effect of the release of funds for the purchase of other types of security Debt repayment thus falls into place as a method by which an additional disinflationary push can be given when this is required on grounds of general economic policy

Apart from quantitatively minor exceptions (and apart from the note issue which is in effect non-interest bearing debt), under modern conditions the public debt can be divided into three categories, according to the length of time before it becomes mature and repayable short-term or floating, medium-term and long-term Typical of the short-term debt is the Treasury bill issue, currently running at about £3,400 mn out of a total floating debt of about £4,500 mn The Treasury bill has a life of only three months, but in the same category of short-term debt must also be included the advances

which the Treasury takes from time to time from its bankers (the Bank of England) or from government departments who have spare cash to invest Such borrowings are known as Ways and Means advances because like the tax revenue (which it will be remembered is debated in the Committee of Ways and Means) they provide the means of covering current expenditure These advances are in a class by themselves, since they are entirely internal transactions and their terms are not revealed They thus only indirectly affect market conditions As well as these, it is now customary to include in the same category of short-term debt, bonds which are reaching maturity, either because they have been issued for a short time only or because their term has nearly run These have been very plentiful in the post-war decade, since much of the war borrowing between 1939 and 1945 was in the form of 3-to-4 or 5-to-7 year bonds Nevertheless in spite of the presence of these other short-term securities the money market continues to be dominated by the vast Treasury bill issue

These short-term securities all belong to the same category because they appeal to the same classes of lenders those who need to hold in their portfolios a certain proportion of liquid or "quick" assets, which they can consider as "near money", in other words those whose need for liquidity may be sudden and unpredictable They include commercial banks, foreign and Commonwealth governments, banks and currency boards, and some firms By far the most important holders, however, are the London Discount Houses, collectively often referred to as the "Money Market", whose business it is to trade in quick assets The discount houses thus have a unique interest in short-term interest rates The British commercial banks are also in a special position in this respect, since they aim to keep a more or less steady (roughly 30 per cent) proportion of their liabilities in respect of deposits in the form of quick assets Finally, within the public sector there are a number of government agencies which also have need of short investments, less ephemeral than Ways and Means Advances Especially important among these is the Exchange Equalization Fund,

which trades sterling bills for gold and foreign exchange, the National Debt Commissioners, who keep the portfolios of the savings banks, and the National Insurance Fund, which in times of full employment has large sums to invest

At the other end of the scale from money market securities is the long-term debt, running for a period of years (roughly ten or more) and in many cases not redeemable at all or only at the option of the government The demand for this type of security is substantially different Long-term debt is necessarily less liquid than short, because when the maturity date lies far in the future there is always the possibility of capital loss from a rise in interest rates, if the securities should have to be sold at short notice The demand side in this long-term market is made up of insurance companies and other financial institutions, including Building Societies and the commercial banks (once their demand for quick assets is satisfied, and especially if the demand for advances to the public is slack), and of trustees, both private and corporate (such as the trade unions) Again there are some government agencies which have some permanent demand for long-term securities, although for the most part they seem to hold them for relatively short periods

In between the money market and the market for long-term securities there is a less clearly defined demand for medium-term government securities, bearing interest rates which are also intermediate The demand side now consists almost wholly of financial institutions who find it convenient to bridge the gap which would otherwise exist in the maturities of their portfolios During the war, however, when most of this medium-term debt had its origin, it had a wide appeal to personal investors who were very willing to tie up their war incomes for a short period of years if reasonably remunerative rates were offered

If there were free markets in all these types of securities the price (or rate of yield) of each would at any moment accurately reflect relative supply and demand When markets are subject to influence by public authorities these "natural" prices may

appear only as tendencies which the authorities may wish to encourage or alternatively seek to curb, or even (although with some difficulty) reverse In reasonably quiet times there tends to be a fairly well defined "structure" or scale of interest rates, running from the low yields of Treasury bills to the highest yields of the "longs", but the relative positions of the different maturities are by no means stable in detail Apart from any difference which may occur on the supply side, the relative demands for different maturities is continually fluctuating, the result is recurrently to put one maturity out of line in the structure Normally this will quickly be compensated through the action of the financial institutions whose interests straddle markets, and who are extremely quick to take advantage of a slight difference in yield The authorities can also take advantage of these temporary shifts in demand whenever they have need to issue new securities It is one of the arts of public borrowing to probe where demand is keenest at any moment

On the supply side also, and even apart from any positive action by the authorities, the structure of the debt is continually shifting, as the efflux of time turns long debt into medium, medium into short and short into mature Hence after a long period of borrowing, such as during a war, there ensues a period of rapidly recurrent need for refinancing The efflux of time makes medium and long-term debt more liquid, more like money and so tending to have a more expansionary effect The process of refinancing gives an opportunity for continuing this trend or readjusting it, as may be required in accordance with general economic policy

§ 3 **The Aims of Policy** During a period of rapid expansion of the debt the traditional aim of policy was to ensure that the floating debt was not increased more than could be helped, for fear that the creation of so much "near money" would lead to an unmanageable inflationary potential which might jeopardize the future borrowing of the government This was the policy which dominated the borrowing of the first world

war But with the skill in credit control evolved during the 1930s together with some additional means (such as control over bank advances) used during the second world war, this danger need no longer be considered serious, at least under war conditions Consequently between 1939 and 1945 policy was directed to two quite different purposes on the one hand to minimize the budgetary charge for servicing the debt, and on the other to arranging a convenient spacing of maturities so as to ease the process of refinancing after the war In both these aims policy was extremely successful, it was inherent in it, however, that the relative size of the floating debt was enormously increased

When war borrowing is over, debt management becomes a process of refinancing, some further factors need then to be taken into account On the one side the government has a chronic (although very fluctuating) need for short-term borrowing to bridge the gaps in the flow of revenue, which tends to be concentrated in the last quarter of the financial year This need may cut across a movement which would be desirable on grounds of general control On the other side, while the Treasury itself has no special requirement for which long-term borrowing is needed, a number of public authorities do require long-term finance the local authorities, especially for housing, the Public Works Loans Board, which largely finances them, and the nationalized industries for their investment programmes These needs may on occasion also conflict with desirable movements on grounds of general economic policy (this was especially true during the period of the great nationalizations) Debt raised for such purposes has a substantially different economic significance from "dead weight" war borrowing, but from the point of view of the lending public, one gilt-edged security is a perfect substitute for another of like maturity, so that on the demand side the two types of long-term borrowing may get in each other's way

For the most part these constraints on the authorities' freedom to conduct debt management in accordance with general economic policy are not serious, and they have consequently

almost complete liberty in the use of debt management as an instrument of control They are faced, however, with three objectives, all worthy in their own right, but which require to be reconciled First there is the desirability of minimizing the budgetary charge of the debt, secondly there is the consideration that low interest rates are conducive to a high rate of capital formation, so necessary for growth, and thirdly there is the desirability of using the monetary instrument to support fiscal policy in the process of compensatory finance These objectives will not by any means necessarily lead to the same type of policy, consequently it is necessary to consider the relative importance which should be assigned to them What this should be depends naturally on the particular economic circumstances, but there are also some general considerations to note

When a large programme of borrowing, such as is necessary to finance a war, is on hand, it is of prime importance to minimize the future cost of the debt by keeping interest rates as low as possible There need be no apprehension of inflationary effects of such a policy, because of the existence of direct controls (for instance of bank deposits) on the one hand and of the very limited opportunities for people to dispose of their incomes in other ways than by lending to the government

In contrast the aim of minimizing the cost of servicing a debt which has already been acquired, although important, is by no means necessarily decisive for policy If the debt is held internally and is subject to taxation (the interest to income and surtaxes, the principal to death duties or other capital taxes), a substantial part of the cost of servicing the debt will be covered by the taxation of debt holders on their holdings In fact the situation is not quite so good as this, since, as is evident from our discussion of the demand side, the debt is largely held by institutions who pay income tax only at the standard rate It is still true, however, that the net budgetary charge of the debt in modern conditions is not very great, it follows that a substantial reduction in the principal (as by a capital levy) would enable only a small reduction to be made

in tax rates, perhaps not more than a few pence on the standard rate[1] When tax rates are very high even this may be quite important In general, however, the aim of maintaining stability in the economy must take precedence over the aim of minimizing the budgetary charge of the debt in a programme of debt management

The effect of the level of interest rates on the process of capital formation has given rise to much controversy, into which we cannot enter here It is, however, generally agreed that its real importance is confined to very long-term investment, involving land and buildings, and becomes progressively less the shorter the life of the assets for which the loan is undertaken Since the stimulus of long-term investment is an important factor in growth, this consideration is probably sufficiently important to justify a policy of keeping the long-term interest rates as low as is consistent with maintaining stability in the economy, but can hardly be said of itself to constitute a major aim of policy On the other hand there is some evidence that savers are sensitive to long-term rates of interest, so that from the point of view of encouraging saving it is undesirable that interest rates should be kept very low This is especially true when the greater part of capital formation is likely to be financed internally

As an instrument of control (both internal and international) the most important aspect of management probably lies in the movement of short-term rates, especially those relating to Treasury bills and advances by the commercial banks Traditionally stability in the money market was maintained by the influence of the authorities on the price of bills, exercised either by directly varying the supply available to the money market by buying or selling them against cash (cheques on the government account at the Bank of England through Open Market Operations), or indirectly, once a tightness had been induced in the market, by forcing the discount houses to restore their liquidity at the penal Bank Rate Terms of bank lending

[1] Cf *The Taxation of War Wealth*, *cit*, Chapter XXII, and discussion pp 209–10 above

could also be influenced (although indirectly and not always satisfactorily) by this means, through the conventional relation which the banks maintained between bank rate and their rates for loans and deposits It was also customary for long-term gilt-edged rates to move in sympathy with money market rates to some extent

Thus a successful dose of rising Bank Rate would be disinflationary all along the line of interest rates If, however, to start with conditions in the money market were very easy and the government had difficulty in avoiding new borrowing itself, to be successful the contractionary movement might have to be so persistent as to run the danger of a serious deflationary potential before the desired tightening was effected This situation was very troublesome in the late 1920s [1]

§ 4 The Technique of Control through Debt Management In the 1930s the need of credit policy was entirely expansionary It was imperative to reduce the whole level of interest rates, both from the view of compensatory finance and capital formation and from that of the increased cost of the debt service due to the steady fall in prices in the late 1920s In the 1920s the finances both of firms and of public authorities had alike been hampered by the high interest rates resulting from the clumsy borrowing of the first world war In fact during the 1930s a technique of debt management was evolved (or perhaps more accurately stumbled upon), which was extremely successful in lowering interest rates and keeping them low It was essentially this technique, elaborated and supported by new direct controls, which was the basis of borrowing policy in the second world war This was a brilliant example of the achievement of the objective of minimizing the budgetary charge during the period of borrowing Since the technique would seem to be available for use at any future time when it

[1] Due primarily to the fact that, owing to a clumsy arrangement of [illegible] the money market was flooded by £2,000 million of war loans which rendered the short bond stage [illegible] of U K Hicks *The Finance of British Government*, cit Chapter XXII

becomes necessary to use the monetary instrument for expansion, it is worth examining it briefly

It would appear that the technique was first developed in the later 1930s, when market conditions were tending to push rates up more than was desired by the authorities The obvious way of meeting such a situation would be to expand the note issue through Treasury borrowing at the Bank of England By this means the commercial banks would find that their cash holdings at the Bank had gone up and would be stimulated to buy additional Treasury bills or even bonds (depending on their liquidity position), thus causing rates to drop This was essentially the policy followed in 1932, which led to the successful conversion of the big block of 5 per cent war loan to a 3½ per cent basis, it was followed again during the war and the early reconstruction period on a considerable scale

Circumstances might arise, however, in which the condition of the exchanges would not permit of a simple expansion of this nature, it was then that the new technique of "departmental intervention" proved useful The basic principle is that the authorities estimate the demand for a particular type of security (especially Treasury Bills, where the weekly tender can be foreseen with a high degree of accuracy), and supply the market with just so much as will balance supply and demand at the rate at which they are aiming The technique depends for success on the authorities being able to satisfy their remaining needs for finance from internal resources For instance the National Debt Commissioners, who manage the funds of the Savings Banks, may be receiving a flow of new savings which they will be anxious to invest These are made available to the authorities to take up whatever form of security is to be operated on In conditions of rising employment the Insurance Fund will also have a continuous inflow of a species of forced saving, other government departments which have funds to invest can also be brought into play The investments thus made are in the interests of debt management, and not those of the institutions concerned, which might well prefer a different balance in their portfolios

With the aid of departmental intervention the Treasury bill in the later 1930s was kept down to the unprecedentedly low level of a fraction of 1 per cent. This led to repercussions which affected the whole structure of interest rates, since both the discount houses and the banks had a strong incentive to expand their holdings of bonds (once their demand for quick assets was satisfied) in order to maintain their profits, sadly diminished by the very low bill rates. This result of departmental intervention is especially likely to be important when the demand from the private sector for bank advances is slack, as it was in the 1930s.

In such a situation the desired level of interest rates, especially of the bill rate, can be attained without any additional credit creation. In fact all that is happening is that saving which is being provided in the private sector is directed into particular channels, chosen by the authorities. These conditions may not, however, always be realized, in which case interest rates can only be forced down by some species of credit expansion. By and large, however, the tightness of the control and the success of the method are reflected in the fact that the Treasury bill rate was to all intents and purposes a "managed" rate from the early 1930s to 1954, when it was decided gradually to work back to the use of the price mechanism to fix the rate, in order that fluctuations in demand, which might be a guide to policy, would be quickly reflected in it. Another indication of the operation of the policy is that throughout the period of the managed rate the gap between the market rate and the less easily controlled longer rates was abnormally large.

During the period of war borrowing not only were both the conditions for departmental intervention especially favourable but additional controls were also available. Bank advances were restricted by direction and the banks' recurring excess liquidity was tied up for six months at a time through frequent demands for compulsory lending by (so called) Treasury Deposit Receipts. Further, a new means of directly influencing long-term rates was evolved: a particular broker (known as the Special Buyer) informally stood ready at all times to buy

back government debt from holders, so that they could never find themselves uncomfortably illiquid. The result of this policy was that, since the risk of capital loss was removed, long-term debt became effectively as liquid as short, demand for it tended to rise (because of the higher return it yielded), and long-term rates tended to fall even faster than short. This was the principal means by which the aim of minimizing the budgetary charge of the debt was so brilliantly achieved. In addition, to support the Special Buyer, the surplus funds of the departments were used not only for short-term accommodation but also effectively as "underwriters" for new issues (in fact the City nicknamed the National Debt Commissioners "the Public Stag"). It was in this way that the authorities were able to take full advantage of the slight variations in demand for maturities of different lengths, which, as we have seen, do normally exist.

War conditions for debt management effectively continued over the early months of the reconstruction period, up at least to the end of 1946. Although the rate of saving by the public began to decline almost immediately after the end of hostilities, so long as shortages, both of consumers' and of producers' goods, were acute, the volume of saving remained sufficient to keep the departments liquid. These conditions were used by the Chancellor (Dalton) to force down interest rates still further, by an intensification of war-time methods, until a $2\frac{1}{2}$ per cent rate for long-term securities was almost established, as compared with the $3\frac{1}{2}$ per cent rate of the war period.

The policy, however, met with increasing resistance and balance of payments difficulties. After the early months of 1947 a given decline in rates could only be achieved by an ever expanding degree of credit creation, which, recognized as an inflationary potential of large and perhaps unmanageable dimensions, helped to shake the confidence of investors in the government's ability to continue the policy. Thus, in spite of the powerful controls which the authorities could still exercise on the one hand, and of the strong vested interest which had been built up in favour of high capital values and low interest

rates on the other, the policy was gradually and tacitly abandoned

The period in which the monetary instrument was used primarily to lower interest rates to the neglect of compensatory finance came to an end at about the time that Sir Stafford Cripps took over from Mr Dalton in the autumn of 1947, although the change in monetary policy was not explicit, the Special Buyer continued his activities on a modified scale and there was no positive attempt to use the monetary instrument as a means of compensatory finance until 1951 On the other hand, after 1947 there was no more forcing down of interest rates by the deliberate creation of additional credit In contrast the new Chancellor set out on a deliberate course of disinflation by fiscal means, striving for the first time out of war conditions to measure the "inflationary gap" and to close it by his budget policy

The tentative revival of the monetary instrument of control as a support for fiscal policy took place only in the autumn of 1951, when for the first time for twenty years (excepting for a short precautionary movement in the first months of the war) Bank Rate was raised, while at the same time the excess liquidity of the market was drastically reduced by the issue of longer-term stock Later the Special Buyer was withdrawn from general availability, to be used only to smooth out particular kinks in market supplies such as must always occur when big concentrations and disbursements have to be made on public account (such, for instance, as the preparation and payment of the periodic disbursements of the Milk Marketing Board) The effect of this tightening was immediately visible in the reduction of holdings of commodity stocks, swollen out of all proportion by the Korean demand acting on the excess liquidity created in the 1940s

It was only gradually and tentatively, however, that the revived monetary instrument was put into operation in Britain It had become so rusty and conditions had changed so much over the course of twenty years that no one could be sure how it would work Moreover in 1951 many, even most, of the

war-time controls over consumption and commodities were still in operation In these circumstances it would have been in any case impossible for the price of money (as represented by the short-term interest rate) to resume its full traditional role, either as an instrument of control or as an indicator of tendencies Gradually, however, as the process of decontrol gathered momentum it became both possible and desirable to work towards a fuller restoration of the monetary instrument, including an active use of bank rate policy For this to be practicable, however, the policy of keeping Treasury Bill rates artificially low by market rationing would have to be suspended, so that the twenty-years-old wide gap between Bank Rate and market rates could be narrowed to a point where Bank Rate could be made effective

By the end of 1954, from a gradually attained pinnacle of almost wholly controlled interest rates there had been a descent to a position in which they could in principle move almost as freely as in the 1920s or even before 1914 How far it will be possible or desirable to maintain this freedom is a matter for the future

It should be noted, however, that Britain has been by no means unique in following this sequence, first of learning to force down interest rates in the hopes of stimulating recovery from the depression of the early 'thirties, secondly of intensifying these methods for the purposes of war finance, and thirdly of gradually (and with considerable difficulty) disentangling the artificial situation which had been built up, in order to return to a flexible monetary instrument Not merely the sequence but the timing of the different stages has been similar in most countries with developed monetary institutions amenable to management, only the precise means differed from country to country, according to the local organization of the money market and banking system (For instance in the United States, in place of the informal Special Buyer, Federal Reserve Banks gave a formal undertaking that they would always buy back government debt at fixed prices)

As a result of this process large programmes of war

borrowing were everywhere carried through at a surprisingly low budgetary charge, but everywhere again excess monetary ease, the result of prolonged credit creation, provided fuel for the Korean boom All countries again found considerable difficulty in retreating from ultra low long-term rates to a position in which all rates could become flexible again, without giving rise to unmanageable capital losses In all the problem had been more or less completely solved by 1954, but only at the cost of some further inflation in order to ease the transition to freedom

Although a great deal of the machinery has now been dismantled, the methods of interest rate control through debt management evolved during the 1930s and 1940s would seem to be a most useful permanent addition to the effectiveness of the monetary instrument of control, giving it much greater flexibility than was possible in a simple regime of bank rate and open market operations With the development of the more precise fiscal instrument, credit control is perhaps not likely ever to be used again as a major instrument, as it was in nineteenth-century England It must be recognized, however, that in spite of its imprecision it has several inherent advantages which are not shared by fiscal policy, apart from its possible effects on the external situation, with which we are not here concerned

In the first place credit policy can operate almost continuously, and if desired by small and gradual steps, whereas in respect of the fiscal instrument there is always a danger that attempted flexibility will be at the expense of effective control of expenditure Secondly a movement in market rates impinges immediately and directly on a sector of the economic process which is especially sensitive to this particular price, because it is an important factor in stock holding This was well understood in the nineteenth century and was demonstrated again in 1951–52 It seems unlikely that any conceivable fiscal change would be so effective on this sector of the economy

An effective use of the monetary instrument, however, is

really only open to advanced countries where banking habits are widespread and well established, and where autonomous financial institutions exist Even then it can only be enjoyed to the full in countries which are not financially dependent on their larger neighbours (Such dependence is a matter of size and economic structure, it has no necessary connection with political dependence [1]) The majority of countries which are now starting on a process of development are therefore at present unable to make much use of the monetary instrument, many of them will never be able to do so India is a striking exception to this generalization

As banking habits develop, however, and as the non-monetary sectors recede before the advance of the exchange economy, it should be possible for such countries to make some use of local credit control As the experience of the Dominions (and especially Canada) demonstrates, this does not necessarily call for the establishment of an independent reserve bank Much more necessary conditions are the presence of commercial banking units which will follow a policy of some local independence (so that the flexibility of local bank money is secured), and probably some flexibility of the currency supply An important contribution can also be made by issues of government securities to the local public

The process of development calls for large capital sums, and while the greater part of these must probably be borrowed abroad, it is very much to the economic and fiscal (as well as the monetary) interest of the developing country that as much as possible should be raised at home This will both eliminate the need for external transfer in servicing the debt, and will provide an outlet for additional incomes which might otherwise tend to move into consumption It is desirable that the citizens should both acquire habits of thrift as they rise from poverty and that they should become accustomed to lend to the government If additional incomes are saved, but deposited in the banks rather than lent to the government, this is still

[1] Cf the dual dependence of New Zealand on Australia and Britain, demonstrated by C G F Simkin, *Fluctuations in a Dependent Economy*

useful since resources will not be diverted to consumption and the banks are very likely to welcome the opportunity of lending to the government locally (so long as they have confidence in its integrity) rather than sending their funds overseas to one of the world monetary centres

There may be savers, however, who will merely hoard their incomes in the form of currency The government should use every means in its power to collect the savings of these, and other potential savers, into its own coffers, by providing suitable means of attracting small savings and attractive means of catching larger ones During the war the belligerents learned a great deal about "selling" government securities to the public, especially savings certificates which could be purchased gradually by means of stamps Indian experience in this field suggests that even where the margin for savings is small, there is a substantial potential source of funds to be garnered in this way, especially if savings groups can be organized (voluntarily) among groups of workers in factories, mines, offices, or it may be on estates and plantations

As regards lending in larger amounts, through the purchase of bonds, in many countries there appears to be a substantial potential market if the government is prepared to offer reasonably attractive terms How much it would require to offer would often depend on the extent to which fiscal and other controls had reduced the attractiveness of other openings for savings, such as real estate mortgages Thus fiscal and monetary policy can be used to support each other even in relatively underdeveloped conditions It might well be worth the government's while to offer fairly attractive terms in order to inculcate the habit of lending to the government

For such a policy to be successful two things are above all necessary In the first place the local bond issues must be well advertised, through banks, lawyers, the local press or whatever media suggest themselves In this respect also the developing countries have much to learn from the advanced countries Secondly, and much more fundamental for success it is essential that the local property owners should not only have

political confidence in the government but should be enthusiastic for development and have confidence in the ability of the government to carry it through To promote this attitude many devices are available, such as the tying of a particular loan to a particular project (as British war loan drives were nominally tied to the purchase of battleships, Spitfires, and so on) In this, as in many other aspects of development, the passport to success is a continuing alertness on the part of the public authorities

CHAPTER XX

THE BUDGET AS AN INSTRUMENT OF POLICY

§ 1 **The Budget and Planning** Of late years few words have been more bandied about in popular discussion than the word "planning", it has been made to cover a multitude of sins, methods and wishful thinking This being so it seems desirable to avoid its use altogether as far as possible It will make for clarity in later discussion, however, if to start with we distinguish briefly the principal meanings which have been given to planning, so as to isolate those which have reference to fiscal policy

The simplest application of the term planning is in connection with land use, physical planning in the sense of the Town and Country Planning Acts This is a perfectly legitimate and important use of the term, but it has little or no fiscal policy significance, so that we are not concerned with it Next comes the integrated comprehensive period plan first made famous by the Russian Five Year Plans This again is primarily planning in a physical sense It is concerned with the lay-out of resources to reach specific economic and political ends, but on account of the very comprehensiveness of the plans it is possible to proceed universally by the method of direct resource allocations, virtually without the intervention of fiscal policy

The planning of the controlled and directed economy of war-time in Britain and some other countries bore some resemblance to the comprehensive type of planning, it was also concerned with the layout of resources to gain a mainly political end, although at the same time it was used (especially in Britain) to further certain social aims (such as better nutrition and greater equality of disposable incomes) as a by-product War-time planning, however, was not in any sense long-period, the

exigencies of defence made it essential that output should be flexible, which implied a large hand to mouth element in the planning process Much more fundamentally the planning of the directed economy in what was still fundamentally a private enterprise organization, working in a free society, was inevitably different from the comprehensive plan of an authoritarian country Although it was essential that policy should try to balance the national accounts as a whole, actual direction was confined to the war effort and services ancillary thereto

Out of the directed economy of war-time there grew, in Britain and in several other countries of Western Europe (most notably Norway and the Netherlands), the semi-controlled (but not directed) economy of the reconstruction period This was at first thought of as a planned economy, and persistent efforts were employed to develop the methods used during the war for permanent use This, however, was planning in quite a new sense Comprehensive physical allocation of resources was abandoned, although direct controls and allocations were retained in particular sectors Persisting scarcities made this inevitable for some time in any case In Britain the controls were used deliberately to reach the special objectives of policy concerned with the establishment of the welfare state

Other countries, notably the U S A and Canada, whose economies had also been largely controlled and directed during the war, more rapidly returned to a free enterprise economy at the end of it (They were in any case much less hampered by war damage and scarcities) But in an important sense the technique of planning was not abandoned, since they continued to use the elaborate statistical mechanism of national accounting built up for the equilibration of the war economy, and to use it both to steer the private sector in the direction required for full employment, and to tailor the public sector so that it would take up any slack or compensate for any tightness in the economy as a whole This is the direction in which Britain has been moving of late years Controls and allocations have been progressively abandoned, partly as a matter of policy,

partly due to the gradual replacement of scarcity by relative abundance

It may be questioned whether the steering of a fundamentally private enterprise economy in this way should be regarded as planning, however large the public sector may be (and as we have seen in Britain public investment now slightly exceeds private investment) Nevertheless, whatever the term used, the preparation and implementation of a general economic policy fixes a wide gulf between an economic organization of this type and the unorganized economies of earlier eras, not excepting those countries which attempted—with sadly inadequate instruments—a counter-cyclical policy in the 1930s In the U S A the growth of the federal government sector since 1940, and the expansion of its influence throughout the economy, through social expenditure and research on the one side and direct taxes on the other, have been little short of staggering [1] The policy implications of the new situation have hardly yet been fully realized

There is one final type of planning which needs to be distinguished before we leave the question of classification the periodic development plan, designed to increase productivity in one or several specific directions Such was the Monnet Plan in France, and such are the development plans of the British nationalized industries The five (or ten) year plans of developing countries are similar in kind, although they normally have a wider range These section plans need to be carefully fitted into general economic policy if they are not to disrupt the balance of the economy Where they are small relative to the whole (as is the case with the British nationalized industries), they constitute just one aspect of securing a general balance of investment, and need pose no particular problems of control Where, however, they are large relatively to the total economy, plans of this type require (as we have seen) special fiscal measures to counteract their over-expansionary effects, they also call for a modification of normal budgetary technique, as we shall discuss later

[1] See above, p 80 and p 292

In Britain the mechanism that was set up to plan the war economy was remarkably simple, almost makeshift The very extent of controls (which under the circumstances were willingly accepted), made a complicated planning organization unnecessary, even if there had been time to set it up, while a great amount of the statistics required was produced as a by-product of the controls Most of what the planners needed to know was thus easily available From the point of view of policy, however, there is one important aspect of war-time planning which needs emphasizing[1] the mechanism (quite naturally in war conditions) was organized round the Cabinet and was hence outside the Treasury The Lord President of the Council became the Minister responsible for the Central Statistical Office and the Economic Section

The framework on which economic policy was built during the war was of course not revealed, but it seems to be closely reflected in the method of planning set out in the first Economic Survey published in 1947 Within the overriding objective of full employment, if possible at stable prices, there were to be sets of budgets (i) for the major industries, including objective targets of manpower and output, in the manner of war-time targets of planes or tanks, (ii) for the main economic factors consumption, investment, exports and imports, consolidated in the national income and expenditure accounts, and accompanied by a manpower budget, and (iii) a special set of calculations concerned with the vital bottlenecks in supply, above all steel, fuel and power and supplies of foreign exchange On the basis of these, as drawn up by the Central Statistical Office and Economic Section, Ministers would then make their final decisions in line with the government's policy It should be noted that the whole planning process was internal to the government, in contrast to the mechanism of some other European countries, notably the Netherlands

The troubles of 1947 the fuel crisis in the spring and the balance of payments crisis in the summer, soon indicated that more formal planning machinery would be required, once the

[1] See above, p 35

core of the war-time controls had been removed, above all the direction of labour. The necessity for this was apparent when it became vitally necessary to cut back investment. It was then found that virtually no information was available of the plans and progress of investment in different parts of the economy. It also became immediately obvious that without either direction of labour or the use of wage incentives (which were incompatible with the wage freeze adopted in the interests of stability) there was no means of attaining the manpower targets, or hence the output targets.

Out of this virtual impasse came a number of experiments in planning organization, designed especially to secure a stricter allocation of resources and thereby better control over the whole range of investment. A hierarchy of permit giving agencies arose, through the central economic planning secretariat, the Ministry of Supply and the Board of Trade; if new money was required also through the Capital Issues Committee, acting under directives from the Treasury. At this stage the new machinery was still developing mainly outside the Treasury, leaving the traditional Treasury control of departments to function in the old way, so far as it was able to do so. This was obviously a situation which could not endure satisfactorily. Either the new side of government policy would absorb more and more, and the Treasury be left with a diminishing control over the public sector, or the new machinery would have to be brought over to the Treasury and integrated with the traditional machinery; it was probably inherent in the British tradition that the second alternative would finally triumph.

When Sir Stafford Cripps succeeded to the Chancellorship in the autumn of 1947 he was already Minister in charge of economic affairs; it was only natural that he should double the role with the Chancellorship; but in fact this apparently fortuitous event quickly determined the issue. Although frequent changes between 1948 and 1953 show that the process was still experimental, the Treasury was gradually shaping itself to absorb the new economic responsibilities of government within its embrace. On the one side the expansion of

Home Finance[1] made possible budgeting (in conjunction with an Investment Programmes Committee) which took account of economic circumstances and trends in a way that had no pre-war precedent • (In fact before the war nobody could rightly say from what dark corner of the Treasury the budget really emerged) On the other hand the expansion of Overseas Finance[1] made room for an organization whose special business it was to look after the balance of payments and the statistics which lay behind it The seal was set on these developments by the transfer in 1953 of the Economic Section from the Cabinet Office to the Treasury, the Head of the Section being given (as we have seen) the title of Chief Economic Adviser to the Government

Thus the central interpretation of economic statistics—ever growing both in volume and accuracy—now takes place within the Treasury The fruits of experience can be observed in the changed content of the Economic Survey on the one hand, and of the National Income and Expenditure Blue Book on the other The Survey has long ceased to talk of targets based mainly on wishful thinking, it has become a document of contemporary economic history, but the history it records is based on much more detailed and accurate statistics Due to the fact that the Economic Survey is published ahead of the budget, it naturally cannot contain explicit forecasts in any detail, it would seem, however, that for internal use it has become a real foundation of policy formation The Blue Books not merely contain vastly more information than was ever available in the old White Paper, but it is organized in a manner which is much more meaningful for forecasting

The first concept of a general economic policy, through national income accounting, set out by Keynes in 1939, and continued essentially unchanged through the reconstruction period, was, as we have seen, in terms of aggregate supplies of factors on the one hand and aggregate demands on them on the other These two aggregates being confronted, an inflationary

[1] See above, pp 36ff

(deflationary) gap would be revealed, which it was the first object of policy to fill This approach, although useful as a first approximation, was both too static and too aggregative to provide an adequate basis for forecasting It is only when the individual sectors can be taken apart and broken down into their components (both functionally, as for instance between consumption and saving, and organizationally, as between demands on resources), that the tendencies of the immediate past can be observed with sufficient closeness to form the basis for judging the next moves This is now being attempted in the tables of inter-sector analysis and especially in the new tentative input/output table

At the same time the end of rationing and the gradual return to a more free economy, together with the revival of the monetary instrument of control, and the greater knowledge which the new statistics supply, can contribute to bring about a simplification in the central planning machinery Allocations of raw materials are no longer rational in a world of sufficient plenty for the price mechanism to work On the other hand the new freedom requires a wider outlook and increasing vigilance The recurrent balance of payments crises in the post-war world were largely due to causes outside the control of Britain, but it cannot fail to be observed that the early Economic Surveys were strangely unconcerned with the overseas situation Again it can fairly be argued that the crisis of 1951 was aggravated by the excess of quick assets in the money market which was an aftermath of the era of forced cheap money, this aspect of the economic situation had not then been integrated with policy

What seems to be called for in the new situation is rather a close and continuous co-operation of all departments and agencies concerned with the factors which determine national income and outlay, under the aegis of the Treasury, than specific planning committees with limited range All of this, however, in turn implies a substantial alteration of the position of the budget in the economy To the problems of gearing the budget to its new tasks we must therefore turn

§ 2 **The Functions of the Budget** The budget is the account of the moneys for which the legislature is responsible In Britain it covers, as we have seen, that part of public outlay on which the House of Commons has the final say, through the Committee of Supply, and the final criticism through the Estimates Committee and the Public Accounts Committee But with the new responsibilities of the public sector the traditional cash record is not sufficient to bring out the economic significance which is required In a sense this new need is supplied in the accounts of the various parts of the public sector presented in the Blue Book These accounts, together with those which have only internal circulation, may be satisfactory for government planners, but from the point of view of Parliament and the outside public it is still the budget that counts, especially since the budget alone can be explicitly forward- as well as backward-looking in any precise way It is therefore ultimately necessary that the budget should be properly adjusted to fit into its new place, while not abandoning its old purposes

Traditionally the main importance of the budget was to assure Parliament of accountability control In its backward-looking aspect it was first to demonstrate that the monies voted for the several public services had been allocated to those purposes, secondly that the funds allocated had either been spent on the services or handed back to the Consolidated Fund In its forward-looking aspect the Budget recorded the planned amounts to be spent on different services and the revenue which would be required to cover them The whole process was complete in the Estimates, the Finance Act and the Appropriation Act, finally reported upon by the Comptroller and Auditor-General The Account was important both in detail, where it was the business of the Treasury, the Comptroller and Auditor-General and the Public Accounts Committee, and in aggregate, where it was the business rather of the Chancellor, the Cabinet and the Committees of the whole House

Merely for the convenience of Members, and without any statutory authority, there grew up the practice (unknown in

earlier times) of summarizing the results and estimates of expenditure and revenue in the Financial Statement This should be a most important document, since it gives the only opportunity of seeing the wood for the trees which is directly related to the financial year and which is effectively forward-looking It is therefore highly desirable that in addition to its traditional role it should reflect the economic significance of the government's performance and policies as closely as possible

For effective accountability control the two most vital of the characteristics of the budgetary system are first, that the account should be truly comprehensive, and second that there should be an annual clearing of the decks (in an accounting sense) between the Departments and the Consolidated Fund These are the two things which the British budgetary procedure was especially designed to secure No funds which are the responsibility of Parliament were to be left out, nor concealed in "agency" or "extraordinary" budgets Expenditure which Parliament regarded as appropriate to be financed out of loan was, however, segregated "Below the Line"—as can be seen in any Financial Statement In fact, except in war periods, only a few items appeared, intermittently, below the line, such as the cost of telephone extension

Annuality was especially carefully looked after Appropriations were for the single accounting period only, and any funds not spent, together with outside receipts by a Department ("Appropriations in Aid") had to be handed back at the end of the period The all-important income tax was voted only for the year Although naturally expenditure and tax collection were continuing processes, special powers were taken annually to regularize these for the period until the budget was passed These precautions and practices continue broadly intact to-day, although as the scope of public activity expands the result becomes somewhat less exact In practice, many departments, especially those with trading or production activities, must be allowed to hold working balances if their operations are to proceed smoothly

Even in the formative stage of budgetary practice (in the second half of the nineteenth century) Parliament evinced a proper interest in another aspect of budgetary organization, which we may call *functional* This seeks to show not merely the aggregate of outlay but also a breakdown between different types of services Very considerable interest was shown by the House of Commons in the relative totals, especially as concerned defence The functional classification was looked after, although only in a very broad way, in the arrangement of the Estimates, which were, and are, published serially on a departmental basis, departments whose business is similar being grouped together When the Estimates are all brought together in the final "balance sheet" of the Financial Statement this arrangement is preserved Further, the Financial Statement contains a series of expenditure tables, summarizing in some detail proposed outlay in different directions grants to local authorities, central contributions to social services, and a number of other headings including colonial, commonwealth and foreign services

The information given in these tables has become more informative and better organized over recent years There is still no means, however, of telling, even from the detailed Estimates, how much any particular service costs which is spread over a number of departments or administered together with other services For this to be possible much more extensive rearrangement of the accounts, and even of the method of accounting, would be required Yet from the point of view of functional efficiency these are just the sort of costs which should be capable of ready check and comparison To this point we shall have to return later

There remains to consider one further classification which is required of the budgetary system by economic category With the beginning of compensatory finance in the 1930s a breakdown of the budget into the leading economic categories, at least so far as current/capital and goods and services/transfers are concerned became a virtual necessity Without these the expenditure effect of public policy could not be judged

The first country to manifest any interest in the economic classification of the budget was Sweden, which established a fairly comprehensive reorganization of the budgetary structure on a current/capital basis in 1938 This was a most interesting experiment, although from the point of view of later needs it scarcely went far enough

With the start of quantified compensatory finance within the framework of national accounting (in Britain only a few years later), not only was something like the Swedish reform desirable, but further economic breakdowns were also required, in order to isolate the true surplus on the current budget on which the system of control fundamentally turns In Britain the process of providing this more detailed economic breakdown grew up entirely outside the framework of the Financial Statement, just as the organizations providing the statistical and economic foundations for policy decisions grew up outside the Treasury The Chancellor's budget consequently remained unreformed and without formal relation to the economic classification which is provided by the Central Statistical Office In the next section we must discuss the possibility of bridging the gap which thus arises between the foundations of policy and the budget account in which it is enshrined

§ 3 **The Budget and the National Accounts** We have seen that the traditional arrangement of the British budget, and the simple cash accounting on which it was based, were designed purely for accountability control So far as ordinary administrative departments are concerned, where there is no question of maintaining or improving assets and independent appropriations in aid (such as fees and fines) are negligible, the system is admirably appropriate for its purpose It is very understandable that the Treasury is most anxious that nothing should be done to disrupt it But for the further purposes with which policy is now concerned it is much less than adequate

Where departments have jobs to perform (as distinct from services to administer) a simple cash record does not have the

same significance Further, for such departments it is highly desirable that there should be a form of accounts which will enable a check to be made on efficiency, as well as on accuracy This category includes not only actual trading departments, for which indeed the need is obvious and widely recognized, but also a considerable variety of semi- or pseudo-trading departments, such as hospitals, Royal Ordnance Factories and Dockyards, departments concerned with road development and works Secondly, and even more important, fiscal policy, whether concerned with stability or growth, calls for an accounting system which will enable a fully economic classification of revenue and expenditure to be made, in order that the central government sector can be consolidated with the rest of the national accounts The problem of budgetary reform is to devise a system which will give weight to these later considerations in addition to accountability control

Taking first the problem of gearing the budget to fiscal policy in the widest sense the first and most fundamental need here is to reveal clearly and accurately the true surplus or deficit on current account, consistent with the definitions of saving in other parts of the economy, because this magnitude measures the contribution of the central government to saving or dissaving in the economy, and hence (according to prevailing economic conditions) its expansionary, contractionary or stabilizing effect The current surplus is of especial importance in the budget of the central government because in the last resort public policy in revenue and expenditure has to act as the balancing factor in the national accounts We must examine this central group of problems in some detail below, in the meantime there are subsidiary problems which also need to be considered

An important aspect of compensatory finance is concerned with budgetary flexibility to meet a change in economic circumstances which may occur in the course of the financial year, this cuts straight across annuality The Swedish budgetary reform scheme attempted to solve this problem by

proposing to vote provisionally at the beginning of the financial year alternative budget plans, one for existing circumstances, one for a deterioration in conditions, such a plan would, however, hardly be less rigid than a single budget It seems clear that such provision for flexibility as can be made without disrupting accountability control, must be made within the ordinary budget framework How far it is possible to go in the direction of flexibility varies (paradoxically) inversely with the tightness of annual control, the better this is the greater the liberties that can be safely taken, and the greater the assurance that they will only be taken when real need arises

In Britain there have recently been a number of successful small examples of flexibility of this nature The acceleration of orders for army clothing to stem the textile recession of 1949 has already been mentioned Similar liberties with the Estimates have more than once been taken to assist sudden emergencies in the Colonies Expenditure of this nature can be financed in the first instance from the Civil Contingencies Fund (which also finances the early stages of new services before they receive their normal Vote in the Estimates) Subsequently emergency expenditure of this type must be embodied in a Supplementary Estimate, where the need for it will be fully discussed On the revenue side purchase tax rates can be changed at different times of the year Even with these opportunities for flexibility, however, so far as fiscal means are concerned, main reliance must be placed on the automatic stabilizers This points again to the need for making full use of the continuously flexible monetary instrument

A somewhat similar problem, also cutting across annuality, is posed by the need, in modern conditions, to budget for projects which may extend over a number of years In the U S A these have led to great difficulty (for instance in respect of the finance of foreign aid or farm supports) It appears to be necessary to get Congress to vote the entire appropriation at the beginning of the programme, hence in that year appropriations enormously exceed outlays, whereby the clarity of the

budget balance is upset, while even then in subsequent years there is no assurance that Congress will not go back on the appropriations it has already made in principle It seems probable that Cabinet government of the British type makes this problem less intractable Once Parliament has accepted a programme, in general it is satisfied to accept year by year the estimate of the outlay upon it which is expected to be made during the year It is evident, however, that estimates of this nature cannot be subject to the same degree of accuracy and hence the same checks as administrative estimates

Continuing programmes have greatly increased in numbers and importance in recent years, for instance the road development programme, capital development in the health services and the expansion of the telephone service The defence production programme also implies some very long term commitments, especially on the development side Nevertheless the continuing programmes with which the British government is concerned are still only of moderate importance relative to the whole In the budgets of colonies and other developing countries this is usually not the case, and it would seem desirable to adjust the budget organization to take account of this fact, for instance by recording each year progress on the schemes involved, together with original and revised estimates to completion In order that the legislatures may appreciate the fiscal implications of the developments it is also wise to set against each the cost of the co-operating labour and materials of a recurrent nature required for full operation

While the solution of these special problems is an increasing requirement for fiscal policy, the central problem remains that of gearing the budget so as to record as nearly as possible the correct current account surplus/deficit For this to be reasonably accurate two things are necessary (i) that the accounts should record amounts payable or receivable as well as actual cash transactions, which may be fortuitous and subject to manœuvre between accounting periods, (ii) that there is an effective separation of current and capital items, the latter consisting of funds available for investment and investment

outlays, loan and borrowing transactions, transfers on capital account and other non-recurrent receipts or payments.

It is recognized that difficult problems of definition arise under all these headings Cash transactions are definite and amenable to exact check, as soon as a receivable/payable (or accrual) base is admitted an element of judgment enters, and the same degree of precision in control is not obtainable Again, many items lie on the border of current and capital, judgment again enters into their classification This is especially true on the outlay side, and more particularly where the final outlay is made not by the Department for which it is appropriated, but by some other authority or agency Nevertheless, while it is unavoidable that there should be some untidy margins of classification, a form of accounting has been worked out and internationally agreed, which on the whole makes these distinctions satisfactorily Before we examine this, however, there are two further matters of classification which require brief mention

If we are interested (as we must be) not merely in the crude magnitude of the budget surplus/deficit, but in its deeper economic significance, it is necessary that the items, especially on the outlay side, should be distinguished according as they represent the purchase of goods or of services from the private sector on the one hand, or transfers on the other, and of these, those that are on social account from payments of national debt interest Secondly it must be possible to tell whether the expenditure impinges in the first place at home or overseas These two distinctions—of which the former is normally the most important—are necessary in order to be able to gauge the effect of the outlays on spending, saving and the balance of payments

We may now examine a summary of a form of accounts which is suitable for the budget of a public authority and which takes proper account of all these distinctions, besides being drawn up on an accruals basis It is in fact virtually identical in form with that used for the accounts of public authorities by the Central Statistical Office in the Blue Book

I Revenue (Income, Current) Account

Incomings	*Outgoings*
1 Tax Revenue	1 Expenditure on goods and services
2 Property income (including trading surpluses)	2 Current grants and subsidies
3 Current grants from overseas	3 Current grants overseas

Balancing item Current surplus/deficit

II Capital (Investment) Account

1 Current surplus deficit	1 Gross fixed investment
2 Capital Transfers (including gifts from abroad)	2 Stock adjustment
3 New Borrowing	3 Capital transfers and gifts
4 Repayment of loans to authority	4 New Lending
	5 Loan repayments by authority

Balancing item Change in liquid assets

The first part of this account covers all transactions on current account, so that the balance represents the true contribution of the authority concerned to saving/dissaving in the economy, it is accordingly carried down to the investment account for disposal in replacement of stocks and fixed capital, new investment, lending and increase of liquid resources The second part covers all transactions on capital account, it will be observed, however, that—apart from gifts and transfers (which in the capital account are of minor importance)—the account falls into two parts, one dealing with real investment, the other with financial transactions It is often useful to divide the account into two accordingly, if the "real" transactions are put first the balancing item to be carried down appears as "funds available for lending" (or requiring to be borrowed), if the financial account is put first it then appears as "funds available for investment" In any case the final balancing item must represent the change in liquidity, which in the case of a national government would appear as a rise in the balance of the government at the central bank, or if the accounts of the

central bank are consolidated with those of the government, would record the change in the country's holding of gold and international money

In the account given above, investment is entered *gross* of depreciation, and no item corresponding to depreciation is shown It is therefore suitable only for departments where a commercial depreciation policy is not followed and where replacement of assets (if any) is provided out of taxation or other extraneous receipts Even if there are real assets which require maintenance this may arise because (as in the case of the Ministry of Works) there are no receipts out of which depreciation can be provided, or because the accounts of a trading or semi-trading department are being kept as if it were an administrative department

Where assets are only a minor matter within departments which are fully accounted for within the budget, it is probably an unnecessary encumbrance to provide specifically for depreciation in the current budget, especially if a practice is followed of normally taking trading and semi-trading activities out of the full scope of the budget (as explained below) In a developing country, however, while assets are being built up, this item will tend not to be small in relation to the whole It is then desirable both in the interest of good financial practice and of stability to provide for depreciation specifically, as well as current maintenance, out of taxation It will also make for a steady rate of development if a fixed charge for new investment is made on the current budget, which can either be carried down directly to the development budget or to an independent Development Fund

It is sometimes objected that a commercial depreciation policy cannot sensibly be applied to assets that have no ascertainable market value This, however, seems to be going too far In the Swedish budget fixed assets are regularly depreciated, the assets being divided into categories according to their expected useful life, and appropriate depreciation periods and rates chosen accordingly It is of course essential in the interests of accountability control that when the periods

have been once chosen and applied they should not be varied Formal depreciation goes far to ensure both that sufficient taxation will be levied to cover necessary maintenance and that assets will be renewed when they fall below standard

The budget account which we have just examined is essentially an administrative record of transactions and commitments So far as the central government is concerned it has developed straight out of the personal account of the sovereign, just as the first business accounts were indistinguishable from the private accounts of their owners As business enterprise developed, however, this form was found not to record effectively the economic position of the business, consequently a slightly more complicated form has been evolved which differs from the administrative account in showing (i) how the trading income is *made* (essentially the difference between sales and purchases), (ii) how it is *divided* between contractual payments (interest, etc) and taxes, capital maintenance and net profits, and (iii) how the net profits are *applied* to investment, to remuneration of the owners (in the case of private enterprise), and to reserves Comparing one year with another, the change in the capital position of the business can then be read at a glance This type of account is briefly summarized below

I OPERATING (PRODUCTION, TRADING) ACCOUNT[1]

Receipts	*Payments*
1 Sales	1 Wages and Salaries
2 Subsidies and other transfers	2 Purchases of Goods and Services
	3 Rent
	4 Taxes (excluding income taxes)
	5 *Less* Increase in Value of Stocks and Work in Progress
	6 Provision for Depreciation

Balancing item Net Operating Surplus

[1] For the construction of an account of this nature, see J R Hicks, *The Social Framework*, 2nd ed , Chapter XIX

II APPROPRIATION (INCOME AND EXPENDITURE) ACCOUNT

Receipts	*Payments*
1 Net Operating Surplus	1 Interest and Dividends
2 Provision for Depreciation and Stock Adjustment	2 Income and Profits taxes
3 Interest and Dividends receivable	
4 Income earned abroad	

Balancing item Undistributed income before appropriating for depreciation and stock maintenance (= gross saving)

III CAPITAL (SAVING/INVESTMENT) ACCOUNT

1 Gross Saving	1 Replacement of Fixed Assets
2 Capital Transfers (net receipts)	2 New internal capital formation (a) fixed, (b) increase in stocks and work in progress
3 Loans (net change)	3 Net purchase of financial assets
4 Additions to Tax and Interest Reserves	4 Net Investment Abroad

Balancing item change in cash

This account is essentially the same as that used in the Blue Book for the public corporations It must at once spring to mind that it would be almost equally appropriate for other types of government activity the trading operations of the Ministry of Food and other Ministries, the Post Office, and with a little adjustment to the road programme[1] and the Ministry of Works and Buildings[2] If it were used further for

[1] For such an adaptation cf J R Hicks, *The Problem of Budgetary Reform*, p 29

[2] This would imply charging rents to Departments for the buildings they occupy Coupled with a proper depreciation policy this might well lead both to more care of buildings (especially requisitioned buildings) by the occupants and to more adequate maintenance

Royal Ordnance Factories, and above all for the hospitals,[1] it would not merely be a more effective check on the disbursement of funds than the present but would point the way directly to a diagnosis of relative efficiency between the establishments The fact that no commercial profit is expected to be made does not affect the adoption of a commercial form of accounting, where it is relevant Rather it serves to demonstrate the true dimensions of the subsidies implied

It is a matter of judgment how far commercial type accounting should be extended to public authorities and agencies which have jobs to perform, in contrast to services to administer, but since in such cases accountability control on a cash basis cannot be effective, there is a strong case for extending it to borderline cases Whenever an authority is thus given commercial accounts its net results are all that need be entered in the budget, so long as the detailed accounts are readily available there need be no diminution of the comprehensiveness of the budget

We must now return to discuss the present arrangement of the budget in the light of these considerations From 1948 to 1954 the Chancellor's budget was (as we have seen) displayed in two arrangements "Conventional" and "Alternative" The conventional form is divided into "above" and "below" the "line", this, as we have seen, implies only a legal distinction Above the line expenditure ties in with the organizational

[1] Perhaps nowhere is the simple cash account more inadequate than in respect of the National Health Service (i) No distinction is made between the employment of officers on ordinary Ministry of Health business at headquarters and on the Service, (ii) owing to the unsatisfactory classification between income and capital account total outlay may vary, substantially and fortuitously, on account of what is really investment and disinvestment, (iii) appropriations in aid, e g for prescriptions and other charges are exceptionally large (which always limits accountability control), and in addition, since their amount cannot be known in advance, the Estimate on the Vote may be very wide of the mark, (iv) the hospitals undertake a variety of trading and semi-trading operations which call for commercial accounting paying patients, board and lodging for staff, production and sale of vegetables In these circumstances accountability control could not be made worse by abandoning the cash method, it would almost certainly be greatly improved, while the account would then acquire some economic significance

classification of Departments in the Estimates, below the line are set out in order the nominal amounts of loan transactions for which the central government is responsible This is essentially the account which the Treasury and the Public Accounts Committee use for accountability control, and could only be altered if they were to change their methods very substantially

The alternative classification was merely a rearrangement of the figures The "overall" totals were identical, but the all-important above the line (in this arrangement called "revenue items") surplus differed—sometimes by many millions of pounds This was because the alternative classification was at pains to empty out from above the line all capital items Thus on the receipts side repayments of capital in Sundry Loans were sent below the line, and the greater part of "Miscellaneous" was revealed as consisting of non-recurrent receipts, on the expenditure side a new, and frequently very large, entry appeared "capital items in civil expenditure" Essentially, however, the two accounts were only a juggling with the same figures, the alternative classification current surplus was not necessarily much nearer to the economic truth than that of the conventional arrangement [1] It was exceedingly muddling for Parliament and the public to be presented with two quite different surpluses on the same budget, further, the alternative classification no longer tied up with the Estimates Finally both arrangements were of course pure cash accounts, so that they could not be integrated with the government accounts arranged for social accounting purposes in the Blue Book

The alternative classification had, it will be seen, no special function or sanction In practice chancellors had to build their budget speeches on the one hand round the conventional classification, because it tied in with the Estimates, and on the other round the National Income White Paper, because it was nearest to the economic truth, although it related to a different

[1] In particular the item "Capital items in civil expenditure" was criticized by the Committee on the Form of Government Accounts (Cmd 7969) as containing many items which were very dubiously of a capital nature

accounting period The question arises whether it would not be possible without a great upheaval to substitute an alternative arrangement that would infuse a real economic meaningfulness into the Chancellor's budget There are three directions in particular in which the alternative classification was lacking In the first place the distinction between current and capital items on the expenditure side was not satisfactory in itself (probably because it is applied at too late a stage in the accounting process), while at the same time it sacrificed such functional classification as the conventional form retains Secondly, there was no breakdown between goods and services and transfers (this applies equally to the current and the capital accounts) Finally there is the matter of cash accounting

When social accounting began the accounts of the Departments were of course wholly directed to the cash basis and traditional classification, this is one of the reasons which made the early steps of the C S O so difficult This, however, is no longer the case, for its own purposes the C S O has to keep the needs of social accounting continually before the Departments They are learning to think in social accounting terms all the way through, not merely at the final stage The time would thus seem to be ripe for an alternative classification which would have the same types of breakdown as the corresponding tables in the Blue Book The question of cash accounting would be more difficult, but here also things are not too hopeless

The most significant differences between the Financial Statement accounts and those of the Central Statistical Office, apart from the categories in which the accounts are presented, are on the expenditure side the difference between issues from the exchequer and what the Departments have actually disbursed by the end of the year, and, on the revenue side, between tax revenue actually received and estimated to have accrued on the year's working Trading operations, it is agreed,[1] would in any case be better removed from the

[1] Cf Report of the Committee on the Form of Government Accounts, *cit*

administrative accounts, and (as we have argued above), semi-trading departments would do better to follow them in many cases Reforms which would bring the Financial Statement into line in a new alternative classification in these respects would seem to be by no means impossible They would not go the whole way in producing a complete accruals account of the activities of government departments, especially those concerned with production There is as yet no direct means of estimating work in progress on government account available even to the C S O Nevertheless such an account would be a very great improvement, and would provide an estimate of the current account surplus which would have a solid basis in economic significance If we then had (as recommended by the Committee of the Form of Government Accounts) a quarterly statement of national income and expenditure (however rough), which would bring the White Paper accounts into line with the financial year, at least a footbridge would be built on which the outside expert could walk warily but safely enough to make the economic implications of the government's policy clear to the public in a way which is just not possible at present

An elaborate machinery for the rational conduct of economic policy has been slowly and painfully built up over what will soon be a period of two decades However imprecise its results may have been in certain conditions, no one can reasonably doubt that we should have been much worse off without it In the modern world of intense international economic competition it is the economist's business to press for the progressive refinement of the machinery in general and of the budget in particular Only thus can fiscal policy reach its full potentialities in promoting the twin aims of stability and growth

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